

Contracts in China – Invaluable Tools with Unique Purposes

Many companies avoid developing contracts with Chinese entities because they just “know” that contracts can’t be enforced in China so they have no value. On the contrary, commercial contracts are enforceable in China as they are in the West. Contracts are essential in China, and in some ways are even more important than in the West.

Contract disputes happen around the world, resulting in commercial conflict, arbitration and even litigation; these outcomes are uncertain. Every jurisdiction has unique attributes and in that sense, China is no different. However, there is a structure of commercial law in China that is logical and within that structure, contracts are routinely enforceable.

However, the value of a contract in China goes beyond the legal dimension. Contracts in China – like anywhere else – define the specific parameters of a commercial relationship, detailing the responsibilities and obligations during normal business and when something goes wrong. In the West, the reality is that after a contract is executed, the document is usually filed away until a problem occurs. In China, the role of a contract includes this liability element, but also plays an important expanded role to bridge the cultural, commercial and regulatory differences between Western and China business environments. These differences are what we call the “China Experience Gap” and contracts are a valuable tool to close that gap.

Contracts as “Instruction Manuals” of the Relationship

China’s commercial environment is far less developed than in the West. Many basic paradigms of behavior in the West between business entities (customers, suppliers, employees and government agencies) are not similarly embedded in China’s commercial DNA. As just one of dozens of examples, in the West there is a common – usually unwritten – rule that a supplier may not change a product’s form, fit, function or material without the customer’s approval. This principle is taken for granted in the West, but it does not have the same roots in China.

Contracts serve to synchronize all “rules of engagement” between business partners in China to minimize innocent mismatches of expectation that can cause extreme problems. When operating in a less sophisticated commercial environment like China, it is wise to follow two principles:

- *If it’s not in writing, it didn’t happen!*
- *If it’s not in writing, it’s not important!*

A contract bridges the “Experience Gap” between Western and Chinese companies and synchronizes expectations across the full range of functional interactions. To be effective, all rules of engagement and requirements need to be defined thoroughly in the contract.

If a requirement is not adequately defined, a Chinese supplier could make the rational but wrong assumption that if it was not important enough to put the requirement in writing, it must not be important. The risk is that Chinese parties may interpret the issue to their benefit, running the risk of serious problems. For example, it is not uncommon for suppliers to change materials without customer approval to reduce cost -- if they are not formally notified that material substitution is not allowed. This is not a dishonest action by the Chinese party. It is a mismatch of understanding that can cause harm, but which is easily overcome with a well-constructed and comprehensive contract.

Think of a contract as the “Instruction Manual” of the relationship, defining all rules of engagement between the parties and eliminating ambiguity that is often the seed of future problems.

Contracts as Liability Documents in China

Contracts also serve as liability documents in China, as they do in the West. Contract terms should be developed just as in the West. Simply stated, there needs to be a basis for defining responsibility, accountability and obligation in the event that a commercial relationship does not pan out as planned.

One challenging issue is defining the jurisdiction of legal principle. Theoretically, a contract can define a jurisdiction anywhere. U.S. companies tend to define their home state. While possible, it is unrealistic to think that Chinese companies will come to a U.S. court to resolve a dispute –

particularly the smaller Chinese companies engaged in export trade. As a practical matter, defining Chinese laws and structuring a dispute resolution process with neutral “Asian” site arbitration (such as Hong Kong, if possible) is more effective. Resulting arbitration results are commonly enforceable in Chinese courts.

Contracts are Relationship Building Tools

China is the last great bastion of “relationship” business. In China, the importance of personal relationships is far greater than in most other business environments. As relationships are developed over a long period of time “Guanxi” is established. Guanxi is a complex concept that pulls together relationship, trust, obligation, friendship and networking. If Guanxi has been developed, it is a powerful linkage; if not, it is a tall barrier to entry.

Contracts are one tool to build this linkage and personal commitment between parties. The contract is a tangible symbol of the relationship. It is signed personally – often over a celebratory social engagement (dinner or banquet) that is punctuated by the leaders of the two entities personally committing their support to the commercial relationship. In a Western sense, this is low impact relationship formality; to the Chinese, it is an important milestone in the development of a sustained relationship between the two parties.

Contract Enforceability in China

Enforcing contracts anywhere in the world – even in the U.S. – is not a straightforward process. U.S. courts are clogged with lawsuits between U.S. companies charging breach of contract. The process can be very expensive and take years with uncertain outcome, even for issues that appear unambiguous per the contract terms.

The situation in China is no different and in one respect can make enforcement more effective. China needs more than US\$100 billion in foreign direct investment annually to maintain the development momentum in their economy. That investment is no longer desired in low technology spaces. China needs the best of product, process and management technologies. If foreign companies do not have a reasonable expectation that their rights will be respected, the pace of foreign investment will slow. Consequently, the Chinese government is working diligently to develop Western-grade contractual law and administrative mechanisms.

This development trajectory of China’s legal administrative process does not mean that enforcement mechanisms are as developed in China as in the West. They are not. However, it is a fact that Western companies win conflicts in China courts and arbitration hearings often and the process is improving. The key points to remember are:

- Contract conflicts are common and outcome-unpredictable everywhere in the world;
- The trajectory of contract law and administration in China is rapidly growing toward Western standards because it is in China’s economic interest to do so;
- Even today, while the process is not yet perfect, Western companies increasingly find effective enforcement of contracts in China.

When to Execute a Contract and When Not to?

In CCA’s judgement, it is advisable to execute contracts with all China suppliers from whom non-trivial and recurring purchases will be made. Any relationship with a China supplier that involves buying material, products or components that are strategic to the Western company’s business model should be based on unambiguous interaction between the supplier and Western company. A contract is the basis of that unambiguous relationship.

With customers, a well-defined and documented, “acknowledged” and formally executed purchase order can suffice to define all aspects of the sale requirement, terms and payment agreement that is formally. For on-going relationships or when special atypical relationship requirements are involved, it is advisable to execute a formal contract that fully defines all detailed rules of engagement to eliminate as much risk of ambiguity as possible.

Summary

For all of the reasons defined in this paper -- whether it is with customers, suppliers, contractors or employees – formal contracts should be developed and executed for all non-trivial business engagements. It is an investment that synchronizes expectations and understanding between the parties as a basis for a sustained positive relationship.