

DON'T TREAD ON ME!

Common pitfalls when signing a chinese MOU/LOI

In previous articles, we have discussed various aspects of Chinese negotiation culture and style with our audience. This time we will focus on Chinese law and the legal documents that are often used, combined with Chinese culture to discuss what you should not do when dealing with a Chinese counterparty.

As businessmen in many countries, Memoranda of Understanding (MOU) and Letters of Intent (LOI) are often used by Chinese companies and businessmen. However, the Chinese use of MOUs and LOIs and the Chinese rules governing these legal documents are so different that they can cause major problems when doing business with China.



Below are the key points to consider when signing a MOU/LOI:

1. Don't make the MOU/LOIs a binding preliminary agreement you don't want.

Art 495 of Civil Code of People Republic of China («China Civil Code») stipulates the concept of «preliminary agreement» in Chinese law:

A Purchase offer, purchase order, subscription book, or the like that the parties agree to contract within a certain time limit shall constitute a preliminary agreement. If one party fails to perform the obligation to contract as agreed in the preliminary agreement, the other party may request it to be liable for breach of the preliminary agreement.

And in China, sometimes the Chinese parties want to sign an **MOU** in a different form, called a «cooperation agreement» or «framework agreement», where they might propose to add a clause to bind another party to sign a contract afterwards. Another possibility is that the «cooperation agreement» or «framework agreement» may contain some very essential terms of the underlying contract, and it may bind the parties not to deviate from these agreed terms when they sign the underlying contract in the future.

In practice, some European parties may think that this is just a **MOU/LOI** by another name, because often the Chinese party will ask their counterpart to sign the «cooperation agreement»/«framework agreement» at a very early stage. Sometimes the Chinese party will even provide a so-called «minutes of the meeting» to ask the counterpart to sign on the spot in the conference room. However, it may contain legal language strong enough to make it binding.

Please be aware that this is not a **MOU/LOI** under another name and should be carefully scrutinized as the real intention may be hidden behind the ambiguous language of the contract. See *Evergrande Property Group Shanghai Ltd. v. Huzhou Nuode Property Ltd.* (2018) Supreme People's Court Minzhong No. 813. (The Supreme People's Court held that the nature of a contract is determined by the terms of the contract and the underlying intention of the parties, and that the share purchase agreement between the parties was actually a preliminary agreement).

Accordingly, don't put the essential terms of the contracts in a **MOU/LOIs** if you think you still have room to negotiate. And the language of the contract should be double-checked for non-binding language so that you don't make the **MOU/LOIs** a binding «preliminary agreement» that forces you into a contract you don't want or that damages another party.



2. Don't be over bind by good faith duty under chinese law

In practice, the Chinese side will often try to turn a MOU/LOI into a concrete commitment when it suits them, and ignore it when it does not. The problem is that, under Chinese law, the Chinese side may be entitled to insist that the MOU/LOI is binding if the foreign side's behavior constitutes bad faith. Moreover, although the Chinese Conflict of Laws does not contain a specific clause on pre-contractual obligations, as a statutory duty imposed for the public good and justice, it is highly uncertain to exclude the application of Chinese law on pre-contractual obligations by introducing a choice of law clause.

The Art 500 of Civil Code of People Republic of China writes:

Where in the course of concluding a contract, a party engages in any of the following conduct, and thereby causes loss to the other party, that party shall be liable in the event of a claim for damages:

- (i) negotiating in bad faith under the pretext of concluding a contract;*
- (ii) intentionally concealing a material fact or supplying false information relating to the conclusion of the contract;*
- (iii) any other conduct which violates the principle of good faith.*

Article 500(i) and (ii) deal with situations where a party negotiates in bad faith to prevent the other party from obtaining a commercial advantage. And clause (iii) of Article 500 appears to be a rather broad provision.

In practice, Chinese judges have set the standard for establishment of claim under item (iii) as follows:

1. One of the contracting parties has breached pre-contractual obligation;
2. This breach of pre-contractual obligation caused the other party to lose the benefit of reliance;

3. The breaching party must be at fault;
4. The claimant must establish the causality between the damage and the breach of pre-contractual obligation by another party.

In practice, it is actually hard to established the causality between the damage and the breach of pre-contractual obligation by another party. However, in practice, it is common for Chinese party to actively prepare for the signing of underlying contract, including using their «Guanxi» (connection) to facilitate the business and governmental arrangement for signing of future agreement, and they are usually pretty angry if the underlying agreement is not signed. *See Shanghai Guotai Chuangye (group) Ltd. V. Maikerui (Shanghai) Storage Ltd. (2018) Supreme People's Court Minshen No.295 (Chinese claimant argue that they are actively helping the defendant to get approval from the government for the signing of the future JV agreement, the Supreme People's court decide that there is breach of pre-contractual obligation, but the claim is groundless because the claimant cannot establish the causality between the damage and the breach).*

Although hard to prove in court, the Chinese party can always sue for it and the litigation can have collateral damage to your reputation and block you from the whole Chinese business community (Quanzi).

Chinese parties are willing to do things for you even if you only give them a verbal promise if they believe in you. So, using very specific contract language to manage not only your expectation but also the Chinese party's expectation. And be careful what you say so that they do not do anything beyond your expectation and ask for something in return. (also, please think about what we talked about a favor must be returned with a favor in Chinese culture in previous article)

In next article, we will continue combine the Chinese culture and law to discuss what is the good practice when you sign a legal document at the preliminary stage with Chinese party.