What If the Chinese Partner Defaults on Joint Venture Contract or Share Transfer Contract?

Description

This is anything but a new topic. There are many essays and articles discoursing on this. However, there is still a great deal of confusion esp in terms of legal doctrines that can be used to support current practice.

Herer are the typical situations where this question often arises: (1) a foreign investor has signed a joint venture contract with the Chinese party in accordance with China Sino-Foreign Equity Joint Venture Law. After execution of the contract, for some reason, the Chinese party (could also be the foreign party) wants to back out of the deal and does not cooperate in obtaining the approval on the joint venture contract from the Chinese authority; (2) a foreign investor has signed a share transfer agreement with the Chinese party under which the foreign party intends to purchase the share or equity interests in a company from the Chinese party. After signing the share transfer agreement, the Chinese party (could be the foreign party also) does not want to proceed to obtain the approval on the transfer deal from the Chinese authority.

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Under Chinese laws regarding foreign investment in China, the aforesaid joint venture contract and share/equity transfer agreement shall have to be approved by the Chinese authority in charge of foreign investment in its jurisdiction. In the absence of the approval, the contract shall not come into effect, which is clearly provided in implementation rules for the Law on Sino-Foreign Equity Joint Venture Enterprises, promulgated by China's cabinet.

Now, as the prerequisite approval is missing in the hypothetical cases, what can the non-defaulting party do now?

This question must have vexed many minds in the legal profession. Before China Supreme Court issued its specific judicial interpretation on it, there is no law that can cast clear lights on the question. In many cases, such contracts or agreements are regarded as "void" without the government approvals.

In contract theory in China, there is a consensus that a contract may not become immediately effective upon execution, so a contract may be first agreed upon execution but may only come into effect upon satisfaction of further condition. For instance, the parties have inserted a clause regarding effectiveness of the contract upon an agreed condition to happen later; also as in our hypothetical cases above where a government approval is required to turn the contract/agreement effective.

Based on the legal doctrine about contract, China Supreme Court has distinguished a particular type of contract in its judicial interpretation regarding foreign investment disputes in China, namely, contracts that have been signed but not yet become effective pending governmental approval. Please note, such contracts are intended to be distinguished from void contracts that are deemed as against public interests and laws.

The natural question ensuing the classification of the new type of contract will be: what legal effects

does this type of contracts have? What if one party refuses to do the work that is expected to give effect to the contract? What legal liability will arise?

These questions find their answers in the China Supreme Court interpretation regarding disputes related to foreign investment in China. According to the interpretation, despite the absence of the requisite approval, the clauses in the joint venture contract relating to application for the approval and other clauses connected with this obligation shall not be affected in terms of their validity. Further, in regard of share transfer agreement, the non-defaulting party can request the defaulting party and the company (whose share/equity interests is being transferred) to apply for government approval, and courts should support such request. In addition, the non-defaulting party can also act to rescind the contract and have the defaulting party liable for the actual loss arising from failure to obtain the approval.

However, it seems that there is no problem in practice in respect of the new type of contract. But indeed, there is an inherent contradiction with the judicial interpretation from the perspective of legal theories supporting such provisions. The major contradiction is: how does the non-defaulting party rely on a contract that has not come into effect yet to pursue the liability of the other party? How can clauses regarding application for approval be held valid while the contract has not become effective?

There are no easy answers to these questions unless we need to rethink about the current legal doctrines regarding validity and effectiveness of contracts under Chinese contract laws.

Personally, I have come to sort out the contradiction by re-interpreting the current provisions in China contract laws and other related laws which is clearly in line with the development of the legal doctrines regarding contract validity. For this part, it will be too academic to write about it here. If you are interested to know more, you can contact Jason Tian, the blogger of this blog.

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