Pre-contract agreement in property deals in China

Description

Deals of selling or buying properties in China involve similar procedures under China property laws. A typical deal often starts from the execution of three-party deposit agreement under which realtor, buyer and seller agree on certain terms of the deal. Under this three-party agreement, the buyer often pays a certain money as deposit (for understanding of “deposit”, please click here) for purpose of binding the seller to the deal. **An indispensable clause in this agreement is one requiring both seller and buyer to sign the formal property sale and purchase contract within certain number of days.** The formal property sale and purchase contract refers to the contract that is formed by the sell and buyer on the online platform built by local real estate authority and will be used in transferring the title of the property. At least, this is the case in Shanghai.

Here basically, there are two documents that are executed by related parties: the preliminary agreement and formal property sale and purchase contract. **In this post, the word “pre-contract” agreement refers to the first-mentioned agreement.**

With development in real estate brokerage practice, realtors, in order to ensure that they will secure their interests in the commission of the deal, come to invent a new deal structure where the realtor will get the parties to sign two legal documents before the execution of the formal property sale and purchase contract: a simple three-party agreement and an informal property sale and purchase agreement signed by seller and buyer only. In this structure, the first three-party simple agreement will just provide for the basic information about the parties and the property in question, and all those clauses related to property deal such as payment schedule, handover, mortgage loan are now shifted to the second informal property sale and purchase contract. The indispensable clause as described above is also set forth in this informal SPA. Accordingly, this informal SPA is also deemed as “pre-contract” agreement in this post.

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The practice of having a pre-contract agreement in which major terms of the deal are set out before the formal SPA, has given rise to some confusion in judicial practice as to how the pre-contract agreement should be treated at law. The main issue here is whether such pre-contract agreement can be regarded by court as able to effectuate title transfer in absence of the formal SPA in case of dispute between seller and buyer before execution of the formal SPA.

Right now, I am advising a foreigner from Australia selling her property in Pudong Shanghai on her situation involving such an informal SPA, the pre-contract agreement.

Basic facts: the Australian lady came to sign two preliminary agreements as described above with the buyer with the brokerage service of CentaLine office in Pudong. In the informal SPA for the apartment, it is agreed that both parties will sign the formal sale and purchase contract for the apartment within 15 days of execution of the pre-contract agreement. The seller accepted a deposit of RMB 80,000 from the buyer. For some reasons (not to elaborate here), the seller is not happy with the buyer trying to postpone the deal, and without advising the first buyer in writing, the seller directly signed the formal SPA with a second buyer who offered a better price. The second deal was struck before the expiry of

the 15 days set out in the pre-contract agreement with the first buyer. Now the first buyer threatened with a lawsuit for damages for breach of pre-contract agreement against the seller. It was until that time when the seller realized that she had made a mistake and that she now needed a lawyer.

In the pre-contract agreement, besides the deposit penalty, it is also agreed that each party may claim a liquidated damages up to 20% of the price of the property against the breaching party, a serious clause that always appears in the formal property sale and purchase contract.

To make it worse, the seller will be further entangled if the first buyer chooses to sue her for real performance of the pre-contract agreement which may lead to final sale to the first buyer in which case, the seller will be in breach with her second buyer. Oops….

The questions before the lawyer are: (1) is this pre-contract agreement legal? (2) Can the first buyer sue for real performance of the pre-contract agreement in order to complete the purchase of the property? (3) what damages can the first buyer claim if he chooses not to sue for real performance?

The answer to the first question is clear: yes. But people and courts are divided as to the latter two questions. Many lawyers and judges said that a pre-contract agreement is not the formal property sale and purchase contract, and should not be treated equally, and the main objective of such a pre-contract agreement is to secure the opportunity to purchase the property. Accordingly, the loss incurred by the buyer because of seller's refusal to sign the formal contract is a loss of opportunity, not the title of the property itself. Therefore, the buyer cannot claim for real performance. However, many argue that as the pre-contract agreement set forth all necessary terms of the deal, there is no reason why it should not constitute a formal contract that can be enforced.

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In practice, in one of the cases I handled before, the court supported one party in enforcing the pre-contract agreement resulting in the party getting the title of the property in the end. This stance of court has been reflected in many precedent cases available from online source. It can be reasonably believed that courts in Shanghai will follow the suit in the future.

With the confusion unclarified, judges may continue to differ in understanding the issue and may deliver different judgments based on the same facts. It takes wits and efforts to convince the judge to lean towards certain understanding in favor of one party or the other, and this requires the lawyer to be fully understand the issues and understand real estate transactions in China.

In answering the questions raised by client through email, I gave the following reply:

> I am not trying to let you down but just bring you to the reality here.
>
> 1. The point regarding cheating government on real contract price is written in the agreement that was signed by your wife. It is clear there and your wife understands it. Now you want to back out of the deal citing the possible legal consequence as the ground, but people will ask "don't you know this at the time of executing the agreement?"
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> What is the your answer? You cannot say you don't know it then. The idea of the using a fake low price is just to avoid taxes.

2. There are a slew of cases in which the party wishing to back out of deal, either sell or buyer, cited the tax evasion as the legal ground to annul the contract signed by the parties. But the court's stance is clear: that is not the legal reason to annul the contract. You can find many case precedent cases online.

Court's rationale is that the evasion of tax is another legal issue to be dealt with by tax authority, but this does not affect the validity of the contract.

3. As for the effectiveness of the informal SPA, it seems that you and your wife are both firm that it is not effective at all. But let me tell you that about two years ago, I represented one party in a very similar case where an informal SPA like the one in your case was signed by the seller inadvertently. Later when the seller was not happy with the buyer, she withdrew the deal. The buyer sued her for real performance of the informal SPA, and the court supported the claim. Unfortunately, I and my colleague represented the seller. Court's rationale is that the informal contract had all the necessary terms constituting a workable contract and therefore binding on the parties.

So I know that it is not that simple that the informal SPA is nothing but a piece of paper. It is just not. I don't know why you would rather listen to others unprofessional advice than listen to me.

In your case, I do see a point to annul the contract because of the implications of involving a foreigner. But I cannot guarantee a success based on my understanding.

4. Also under china contract law, there is a specific clause saying a party can either choose to apply the deposit rule (http://www.sinoblawg.com/?p=134) or choose to claim damages stemming from the breach of the other party. Of course, the party cannot have both.

If he chooses to sue for deposit, he will only get 160,000 back at most in the end, without regard to my claim of annulling the agreement. But if he chooses to sue for damages, he will for sure claim to sue for a much bigger clause. Otherwise, he will be mocking or joking himself by retreating from your offer and then suing for a lesser amount.

You need to know that there is a breach clause in the informal SPA where the first buyer can claim up to 20% of the price of the deal. I believe if he goes to court, he will based his claim on this clause.

I am not saying that he will succeed in wining that big sum of money, but I cannot tell you how much he can get at the end of day.

Besides, he may also sue for real performance.

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Date Created
July 2013
Author
admin