

Effective Enforcement of Contract Rights in Chinese Outsourcing Contracts

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Effective enforcement of contract rights is on virtually every customer's short list of concerns when considering outsourced manufacturing and development outsourcing services from suppliers in China. Over the last 20 years, companies in the West have turned to China for not only the manufacture of their products, but also design, engineering and testing (development) of the next generation of products. The change in companies' value chains has not only helped to reduce development cycle time and costs, but it has also forced companies to re-think their positions toward their suppliers. As China builds on its position as a manufacturing and related value-added services powerhouse, its ability to assure customers that they can effectively enforce contract rights and protect their interests in Chinese outsourced manufacturing and development outsourcing agreements stands as a key challenge to its success.

In considering the issue of contractual enforcement, focus often tends toward dispute resolution mechanisms that can be utilized either to compel performance in the face of actual or threatened nonperformance or to address damages or other remedies for failed performance. Emphasis generally is placed on

traditional means of dispute resolution, including mediation, arbitration, litigation and injunctive relief, and on satisfaction of awards and judgments. However, while the availability and effectiveness of such dispute resolution forms a critical component of contract enforcement, actual dispute resolution alone is far too narrow a focus for evaluating the effectiveness of contract enforcement.

Effective contract enforcement should be viewed on a broader systematic basis, as part of the overall contractual arrangement and its context. This perspective encompasses the contract's legal environment, including the availability of traditional dispute resolution mechanisms, but also includes contract-specific considerations, such as the structure of performance established under the contract. Further, it must take into account extra-contractual considerations, such as the broader relationship between the parties, and the market visibility and reputation of the supplier and company.

This article identifies some of the important issues facing customers as they assess effective enforcement of outsourcing contracts with Chinese suppliers within a manufacturing

outsourcing context. The objective of this discussion is to assist prospective companies in evaluating the viability of outsourcing arrangements with Chinese suppliers.

Inventory of Considerations – Acceptance of Relatively Few Absolutes

When a customer evaluates the viability of an outsourcing opportunity, it inevitably balances the criticality of *specific contract compliance* with the reality of *actual contractual performance*. In jurisdictions with reasonable predictability and assurance of contract enforcement, the evaluation can often be relatively straightforward, although it is never completely without risk. An assessment conducted in this context is ultimately aimed at determining whether a particular product or service outsourcing arrangement meets the customer's acceptable risk profile. An analysis of this nature is a challenge in any market environment, but particularly so in the rapidly evolving market of Chinese suppliers.

Enforcement mechanisms available for an outsourcing contract can be divided into two major groupings. The first relates to the structural and operational factors established both by contract and by extra-contractual environmental considerations. These factors focus primarily on operational safeguards and mechanisms that provide practical protections in order to assure performance and, to a lesser extent, on actual enforcement.

The second category comprises more conventional enforcement mechanisms. In China, as in any commercial jurisdiction, these mechanisms include all of the traditional dispute resolution devices (such as alternative dispute resolution and litigation) and related considerations (such as choice of law, procedures and forum). It is with this second category of enforcement mechanisms that China offers particular challenges, graphically illustrated by the fact that it has only recently formally embraced the concept of rule-of-law.

China is seeking to create a business-friendly environment characterized by predictable legal enforcement of contract rights. China has made significant strides in its development of a national business atmosphere in which contract enforcement is

reliable and consistent with international commercial standards and practices. Nonetheless, the establishment of effective, predictable enforcement mechanisms represents a relatively new endeavor in China.

Businesses operating in today's China, then, may be less certain that contractual agreements will be supported by effective legal enforcement as compared, for example, to national jurisdictions with long histories of commercial practice. This reality means that the first grouping of enforcement mechanisms described above — emphasizing contract structures and operational arrangements — has heightened significance for outsourcing from China.

Contract Structure and Operational Arrangements to Avoid Disputes

Some of the most effective contract enforcement techniques in outsourcing transactions have been dispute avoidance strategies that are embodied in the scope, structure and operation of the outsourcing relationship. Savvy buyers of products and services have long worked to scope and structure their outsourcing arrangements to avoid or minimize the likelihood of disputes and to eliminate high-risk situations. This is because, no matter how sophisticated and established the dispute resolution environment, actual dispute resolution activities are ultimately distracting, costly and non-productive.

Proactive approaches and arrangements designed to avoid problems in the first place generally provide a superior alternative to dispute resolution strategies. These may include:

- Payment schedules tied to actual delivery and acceptance by the buyer.
- Strategic scoping of the outsourcing agreement to ensure that the customer retains control of the overall production/performance process (e.g., limit outsourcing to discrete components or phases or utilize multi-supplier arrangements).
- Careful due diligence in supplier selection and monitoring (e.g., to ensure that the supplier is motivated to preserve and protect its reputation and the integrity of its operation).

- Effective customer-side audit and other quality controls, including inspection and reporting.
- Effective and legitimate utilization of business incentives (e.g., retention, margin improvement or expansion of business).

Proactive dispute avoidance measures including a lengthy "get to know you" process and dialogue about issues, developed and tested over time as regular good practices in any outsourcing transaction, are readily applicable. They take on added importance when outsourcing in China, where the options and mechanisms of dispute resolution may be less developed and certain.

Dispute Resolution Considerations in China

Despite best efforts to scope, structure and operate outsourcing relationships to avoid the need for active dispute resolution mechanisms, unforeseen market externalities cause buyer-supplier disputes requiring formalized dispute resolution processes. In the case of Chinese suppliers, all of the basic dispute resolution options are available in China. In some cases, however, these options present unique requirements and considerations.

Effective dispute resolution strategies, ranging from structured issue escalation within each of the contracting parties to mediation and even arbitration, are available in China and are typically well-suited to address issues with Chinese suppliers. Prospective outsourcing companies should be aware that, from a cultural perspective, informal dispute resolution tends to be more consistent with important elements of Chinese culture and tradition, including Confucian ethics, the characteristic desire for harmony and the desire to maintain one's honor and reputation.

Consequently, in outsourcing arrangements with Chinese suppliers, there is a marked preference to resolve disputes through alternative dispute resolution efforts, mainly through arbitration (not mediation), rather than through litigation. In fact, public litigation has historically carried a connotation of criminal proceedings in China and may be viewed as humiliating to the parties involved. There has also been a bias against resorting to litigation and court

administered third-party mediation because of a lack of judicial independence.

Cultural realities and other considerations explain why larger outsourcing arrangements with Chinese suppliers very often include well-structured but informal dispute escalation procedures. For example, parties may be contractually obligated to address and escalate issues within their respective management groups in order to avoid or resolve disputes without litigation. Other, more formal mediation arrangements that are legally supportable while still maintaining sensitivity to Chinese cultural and social norms may also be incorporated into outsourcing contracts.

Nonetheless, resort to formal dispute resolution proceedings may be inevitable, and a buyer outsourcing from a Chinese supplier must account for this possibility. In this regard, both litigation and arbitration are available methods of dispute resolution with Chinese suppliers but each carries important considerations and qualifications.

Subject to certain important limitations, an outsourcing contract between a Chinese provider and a foreign customer may provide that the law of a national jurisdiction other than the mainland of China is to govern the contract and that any disputes under the contract will be resolved through proceedings conducted outside China. In this regard, however, two important limitations must be noted:

- Despite a contract's generally valid choice of law, some issues remain subject to Chinese law. These include certain issues concerning intellectual property ownership, labor laws, land ownership, insolvency and enforcement of foreign judgments or awards.
- Courts in China are far more likely to enforce a foreign arbitral award than to uphold the judgment of a foreign court.¹

Litigation in China

Since 1979, China has had a judicial system that will hear and resolve commercial disputes. However, beyond the standard concerns of litigation in even more established judicial environments, including

inefficiency, cost and time, commercial litigation in China raises a number of significant concerns — many related to the lack of a litigation tradition for resolving commercial disputes and the relative infancy of its judicial system.

For a variety of reasons, including concerns with the still-developing judiciary, arbitration is becoming the predominant formal mechanism for resolution of contract disputes in China. As part of its sweeping enactment of commercial laws over the past 20 years, China enacted a comprehensive arbitration law in 1994 that, in tandem with numerous opinions issued

by the Supreme People’s Court, has helped to meet international arbitration law standards in terms of both scope and content.²

Practically speaking, three types of arbitration are recognized in China: domestic arbitration, foreign-related arbitration and foreign arbitration. The first two categories of arbitration describe proceedings that are conducted and enforced in China under Chinese laws. The latter category refers to arbitration conducted outside China but enforceable within the country under the New York Convention. The following table describes these distinctions:

	DOMESTIC ARBITRATION	FOREIGN-RELATED ARBITRATION	FOREIGN ARBITRATION
NON-DOMESTIC DISPUTES		✓	✓
CONDUCTED BY A CHINESE ARBITRATION INSTITUTION	✓	✓	
CONDUCTED BY A FOREIGN ARBITRATION INSTITUTION			✓
ENFORCEABILITY IN CHINA	✓	✓	✓
APPLICABLE LEGISLATION OR CONVENTION	Arbitration Law and Civil Procedure Law	Arbitration Law and Civil Procedure Law	New York Convention

For arbitrations taking place in China, procedures that are categorized as “foreign-related” can offer the participating parties broader options, and the designation can be an important consideration. A dispute meeting one of several specific elements can be recognized as “foreign-related” by Chinese courts. These elements include:³

- One or both parties in the dispute are foreign persons or are organizations that are domiciled in a foreign country.
- The subject matter of the dispute is located in a foreign country.
- The facts that establish, change or terminate the contract between the parties occur outside China.

A potentially significant qualification with respect to the dispute characterization issue is the fact that, for this determination, both foreign-invested enterprises

(FIEs) and wholly foreign-owned enterprises (WFOEs) are considered Chinese persons because they are Chinese-formed entities. While it is not a prerequisite that a local entity be formed and utilized in outsourcing transactions by foreign customers, one or another of these structures is often used as a vehicle for various local operational reasons.

Outsourcing transactions in which such Chinese-formed entities are common include shared services captive structures. In such cases, use of an FIE or WFOE structure increases the likelihood that a foreign buyer may find its contractual obligations with Chinese suppliers governed by Chinese law. As a result, any disputes may be characterized as “domestic.”⁴

The consequence of this domestic characterization can be significant. For example, in both a recognized foreign-related arbitration and a foreign arbitration,

the court's ability to deny enforcement is far narrower than in a domestic arbitration. In contrast, the People's Court may deny enforcement of a domestic arbitral award if it finds insufficient evidence to enforce, or if it determines that the law (which would necessarily be Chinese law) has been erroneously applied. Neither of these defenses would be available to deny enforcement in a foreign-related arbitration or in a foreign arbitration. Accordingly, there is far less certainty regarding judicial enforcement in the case of Chinese domestic arbitrations, a consideration that may effectively defeat the entire objective of arbitration.

One of the main forums for conducting foreign-related arbitrations in China is the China International Economic Trade Arbitration Commission (CIETAC), a state-sponsored organization that was formed in 1956. Despite significant modernization of its procedures in recent years, CIETAC proceedings continue to be viewed with some concern by the international business community. These concerns include issues regarding transparency of arbitrator compensation and even the possibility of improper influence and pressure being brought on the arbitrators.

To the extent that a dispute results in an award or judgment, a range of issues arises relative to the enforceability of that award or judgment against a Chinese supplier, irrespective of the forum proceeding or governing law applied. Applications for enforcement of arbitral awards are made to local intermediate Chinese courts. The basis of non-enforcement of otherwise enforceable foreign-related and foreign arbitral awards, however, is limited to procedural violations such as:

- Lack of jurisdiction of the arbitration proceeding.
- Lack of a valid arbitration agreement.
- Discrepancies in the proceeding, such as the improper appointment of an arbitrator or lack of appropriate notice to a party.

Finally, the most common reason for ultimate non-enforcement of arbitral awards (domestic and foreign-related) is one that is not limited to China: lack of assets. Such a situation may involve actual

bankruptcy or insolvency. Often, however, it includes cases in which the plaintiff or court simply cannot locate assets.

Mediation among the disputing parties without third-party involvement is often a common initial remedy. When parties attempt to litigate their disputes in a Chinese court, there is often pressure from the judges (acting on political orders from Beijing) to have the parties mediate the problem rather than give a final judgment. Courts often coerce the parties to accept compromise. And while compromise is not seen to be a sign of weakness in China, it often leaves the parties dissatisfied and creates the perception that the law remains a distant, irrelevant consideration.

Conclusion

Enforcement of contract rights is a critical consideration in any commercial transaction. As China works to increase its role as a provider of outsourced manufacturing and development services, the legal system and practice necessary to ensure efficient and predictable dispute resolution will certainly develop. With this legal evolution, there should come increasingly favorable international perceptions of China's viability as an outsourcing environment, and the scale and quantity of outsourcing transactions involving Chinese can steadily — and sharply — increase.

In the meantime, companies looking to source from Chinese suppliers must carefully consider the scope and structure of their contractual arrangements. They must also carefully assess the effectiveness of their arrangements to both avoid and address disputes with outsourcing suppliers. With diligent consideration and planning, however, companies can approach the Chinese market with a level of confidence that will enable them to take advantage of the many and growing opportunities in what is, and promises to remain, one of the most dynamic markets in the world. ♦

Endnotes

- ¹ China is a signatory to the New York Convention, and its courts are therefore obliged to recognize and enforce arbitral awards of other signatory countries, including the United States. On the other hand, the United States and a number of other countries have not signed treaties on

recognition and enforcement of foreign judgments. Consequently, Chinese courts have no similar obligation to enforce court judgments of those countries.

² Beyond issues associated with the infancy of China's judicial system and the inexperience of its judges, principal concerns include the means of judicial appointment and compensation and the overall level of judicial qualification in many parts of the country.

³ These elements were adopted by the Supreme People's Court in defining "foreign-related civil litigation" in a 1992 opinion. No such specific guidance has been given for "foreign-related" arbitration, leaving the matter less certain. Further, under Article 20(7) of the Consultation Draft of the Provisions for Handling of Foreign and Foreign-related Arbitration Cases by the People's Court (31 Dec 2003), there appears to be a likelihood that an agreement between parties for arbitration outside of China may be found void if there is no "foreign element."

⁴ Article 126 of Contract Law of China.

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