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A Guide to Choosing Governing Law and Dispute Resolution for China Commercial Contracts

CHINA REGULATION WATCH[1]

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Taking legal actions with respect to a contract dispute in an international transaction, where the counterparty resides in a different jurisdiction, can be challenging due to differences in law, judicial procedure, and enforcement of judgments. To minimize uncertainty and ensure contractual enforceability, counsel for each party often pushes to use the governing law and dispute resolution mechanism of their own jurisdiction. This negotiation can take on greater significance when one party is located in the People's Republic of China (the "PRC" or "China") and the other is not, due to often profound differences in legal systems. Selecting a foreign governing law and dispute resolution mechanism is not, however, always possible, or always the best choice for a foreign company.[2]

This China Regulation Watch addresses the choice of governing law and dispute resolution clauses in commercial contracts between foreign companies and China companies,[3] and explores the challenges foreign companies face with litigation or arbitration in China, compared to the obstacles that arise when foreign companies attempt to enforce foreign judgments and arbitration awards in China. Finally, this article also provides practical recommendations for foreign companies when selecting the governing law and dispute resolution mechanisms based on the cooperation context in international transactions that involve a China counterparty.

I. Governing Law and Dispute Resolution in International Transactions

When negotiating a contract with a counterparty located in a different country, each party generally wishes to use the governing law and dispute resolution mechanism of their own jurisdiction. There are many reasons for this preference, which may include (i) greater familiarity with their own country's laws, litigation procedures and language, (ii) easier access to and familiarity with litigation counsel in their own country, and (iii) a perception of "home court

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[2] In this legal update, "foreign" means foreign from the perspective of China. Foreign governing law and dispute resolution mechanism therefore means the governing law and dispute resolution mechanism of any country other than China.

[3] In this legal update, "foreign company" refers to a company established under the laws of a jurisdiction other than China, and a "China company" refers to a company established under the laws of China, including foreign invested enterprises established in China such as wholly foreign-owned entities and joint ventures.

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advantage" or favorable judicial bias in their own jurisdiction. Resistance to using the governing law and dispute resolution mechanism of the other party's jurisdiction is often driven by the exact same considerations in reverse, meaning that the other party would benefit from these advantages, and they would be correspondingly disadvantaged. A common compromise is to choose the laws and dispute resolution mechanism of a third "neutral" country with well-respected arbitration institutions that have experience resolving disputes related to complex commercial agreements.

Aligning the governing law with the venue chosen for dispute resolution can help to reduce confusion and costs in the event of an actual dispute. If the parties choose Delaware governing law with arbitration in Hong Kong, for example, it might be necessary to engage both Delaware and Hong Kong litigation counsel – one for substantive matters, and the other for procedural or local practice matters. The Delaware lawyers might need to appear in Hong Kong at various stages of the arbitration. A Hong Kong based arbitrator or arbitration panel may need a crash course in the relevant provisions of and judicial precedent with respect to Delaware law. The challenges could escalate if the legal systems of the governing law jurisdiction and the dispute resolution venue do not share a common British heritage.

II. When Can Foreign Law and Dispute Resolution be Used in China Commercial Contracts?

Parties to a China commercial contract can only choose foreign law and dispute resolution when the contract has a "foreign relation."[4] This foreign relation element is present if at least one of the contracting parties is a foreign company or the contract's subject matter is not related to China.[5] In this context, foreign invested enterprises established in China are considered China companies rather than foreign companies.[6] As a result, when a true China domestic company, meaning a company established in China with the entire equity interest held by other China domestic companies or PRC citizens, enters into a contract with a foreign invested enterprise established in China, that contract generally must be governed by the laws of China, with disputes resolved in the courts or through arbitration in China.

In addition, certain types of commercial contracts between a foreign company and a China company must always be governed by the laws of China even if foreign relation exists. These contracts include, but are not limited to:

[4] Article 3 of the Law of the People's Republic of China on Legal Application of Foreign-related Civil Relations (中华人民共和国涉外民事关系法律适用法).

[5] Article 1 of the Supreme People's Court Interpretation on Several Issues Concerning the Application of the People's Republic of Law on Foreign-Related Civil Relations (I)" (最高人民法院关于适用《中华人民共和国涉外民事关系法律适用法》若干问题的 解释（一）).

[6] There is one exception to this general rules. Contracts with wholly foreign-owned enterprises established in a free trade zone in China are considered to have a "foreign relation," and therefore the parties to those contracts are permitted to choose a foreign governing law and dispute resolution mechanism. See Article 9 of the Supreme People's Court's Opinions on Providing Judicial Protection for the Construction of Free Trade Zones (最高人民法院关于为自由贸易试验区建设提供司法保障的意见).

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(i) contracts related to joint ventures established in China;[7]
(ii) contracts related to labor and employment matters;
(iii) contracts related to safety matters, including food and public health safety, environmental safety and financial safety (such as foreign exchange administration);
(iv) contracts related to the exploitation/development of nature resources in China;
(v) contracts related to consumers based in China, such as online terms of service and privacy policies; and
(iv) contracts related to real property.[8]

In commercial contracts between a foreign company and a China company that do not fall into these categories, the parties generally are permitted to use a foreign law to govern the contract and to resolve disputes under a foreign dispute resolution mechanism. When the parties are permitted to choose, for reasons discussed in greater detail below, the choices are generally among the three options listed in the table below.

China Commercial Contract with Foreign Relation Options		
	Governing Law	**Dispute Resolution**
1.	China	Arbitration in China
2.	Foreign party home country law	Arbitration in foreign party home country
3.	Third "neutral" country law	Arbitration in third "neutral" country

III. Litigation and Arbitration in China

Enforcing judgments against a company based in China is less complicated from a procedural perspective if the contract is governed by the laws of China and disputes are resolved in the courts of China. Foreign companies are often reluctant to accept this arrangement due to the following common concerns:

(i) Lack of Judicial Independence. China's courts, unlike those of most liberal democracies, are not independent from other branches of the government or from the Communist Party of China ("CPC" or the "Party"). The Supreme People's Court (最高人民法院), the highest judicial authority in China, is under the supervision of the National People's Congress, the highest legislative authority in China. In addition, the chief judge of the Supreme People's Court, and the chief judges of each lower level of the People's Court, frequently also serve as the Party secretary of the same court.[9] This arrangement naturally raises concerns about the potential influence of Party ideology or other policy considerations on court decisions.

[7] Pursuant to the Foreign Investment Law of the People's Republic of China (中华人民共和国外商投资法), which became effective on January 1, 2020, Sino-foreign equity joint venture enterprises and Sino-foreign cooperative joint venture enterprises ceased to exist, and any previously established joint venture is required to convert into foreign invested entity in accordance with the Company Law of the People's Republic of China (中华人民共和国公司法) prior to December 31, 2025.
[8] See the Law of the People's Republic of China on Legal Application of Foreign-related Civil Relations (中华人民共和国涉外民事关系法律适用法).
[9] Each government organization in China generally has a top government leader and a top Party leader, with the Party leader outranking the government leader when they are not the same person.

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(ii) Relevant Expertise and Linguistic Challenges. International commercial agreements are often in English and frequently include complex provisions that have evolved over many decades of use. Although all documents and other textual evidence will be translated into Chinese by a certified translation company, there may still be concerns about local judges in China misinterpreting the translated documents or misunderstanding the underlying legal concepts.

(iii) Local Protectionism. Large companies in China may have outsized influence over the decisions of courts in their district. In China, when two domestic companies from different cities or provinces negotiate a commercial contract, each generally pushes to have disputes resolved in their own local courts. Under China's system, local governments appoint local judges and control the budgets for the courts. In addition, promotion of local government officials is often based on key metrics, which generally include economic growth. The structure of this system creates opportunities and incentives for local government officials to intervene in court cases to protect companies that contribute to economic growth, local tax revenue, off-budget funds, and other local projects.

Although foreign companies generally oppose using the laws of China to govern their commercial agreements, they don't always have a choice. In addition to the situations listed above in which the laws of China must be used, there are many more situations when a foreign law can be used but the China party opposes this outcome and has the negotiating power to ensure their preference is reflected in the final agreement. For example, when a small foreign vendor or service provider is selling to a state-owned enterprise or another large company in China, the China company will often be able to insist on using the laws of China to govern the contract and China's courts for dispute resolution.

When the laws of China must be used, either due to the relative negotiating power of the parties or because this is required under PRC law, the foreign party should consider requesting arbitration rather than courts for dispute resolution. Arbitration has many advantages over courts in most jurisdictions, including confidentiality and efficiency, but in China arbitration also partially mitigates some of the concerns noted above with respect to China's courts. For example, the contracting parties can choose English as the language of arbitration, and they can potentially choose multiple arbitrators with different nationalities and backgrounds. Although arbitration tribunals in China are not truly independent from any influence of local governments or the Party in general, choosing arbitration in a large city that is not the headquarters for the China company should help. In addition, the foreign party can point out to their China counterpart that this approach may be in the interest of both parties since the China counterpart would likely face challenges enforcing a China court judgement against the foreign party in the foreign party's home country.

IV. Enforcing Foreign Court Judgments and Arbitration Awards in China

While foreign companies generally prefer to use either their home country or a third country jurisdiction for governing law and dispute resolution in their China commercial contracts, it is often very difficult or even impossible to enforce a foreign court judgement in

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China. There are more established mechanisms for enforcing a foreign arbitration award in China, but this too can become challenging if the award contradicts China's public policy, which could be influenced by political, national security or sovereignty concerns.

A. Recognition and Enforcement of Foreign Court Judgments in China

There are two pathways to recognizing and enforcing a foreign court judgment in China.[10] One pathway is available if the foreign court is located in a country that has a bilateral treaty with China for mutual judicial assistance. If such a treaty exists, then the foreign court judgment can be recognized and enforced in China according to the procedures outlined in the relevant treaty. As of the date of this legal update, China has entered into mutual judicial assistance treaties with respect to recognition and enforcement of judgements with 34 countries, including some large European nations such as France, Italy and Spain.[11] The United States and China have not, however, signed a mutual judicial assistance treaty.

The other pathway to recognizing and enforcing a foreign court judgement in China is based on the principle of reciprocity. Historically, the standard for establishing the existence of a reciprocal relationship for court judgement enforcement has been stringent, typically requiring the prior recognition and enforcement of a China court judgement in the foreign country. In recent years the standard has relaxed slightly, now just requiring that the laws of the foreign country where the country judgement is issued must stipulate that civil and commercial judgments made by courts in China can be recognized and enforced.[12] Nonetheless, due to challenges in demonstrating the existence of a reciprocal judicial assistance relationship between China and a foreign country, there is a great deal of uncertainty as to whether a foreign court judgement from a non-treaty country will be recognized and enforced in China.

China's courts have recognized and enforced very few foreign court judgements. The Vice President of the Supreme People's Court, Tao Kaiyuan (陶凯元), indicated that between 2018 and 2020 China's courts recognized and enforced a total of 1,142 civil and commercial

[10] The Civil Procedure Law of the People's Republic of China (中华人民共和国民事诉讼法) was first issued by the Standing Committee of the National People's Congress (全国人民代表大会常务委员会) on April 9, 1991, with the latest amendment issued on December 24, 2021, effective on January 1, 2022. According to Article 289 of Civil Procedure Law, having received an application or a request for recognition and execution of a legally effective judgment or ruling of a foreign court, a people's court shall review such judgment or ruling in accordance with international treaties concluded or acceded to by China or based on the principle of reciprocity. If, upon such review, the people's court considers that such judgment or ruling neither contradicts the basic principles of China laws nor jeopardizes State sovereignty, security and the public interest, it shall decide to recognize its effectiveness. If such judgment or ruling shall be enforced, the people's court shall issue an order of enforcement, which shall be implemented in accordance with the relevant laws and regulations. If such judgment or ruling contradicts the basic principles of the China laws or jeopardizes State sovereignty, security or the public interest, the people's court shall refuse to recognize and enforce the judgment or ruling.

[11] As of the date of this legal update, China has entered into bilateral treaties with 34 countries with respect to recognition and enforcement of judgements, consisting of Bosnia and Herzegovina, Algeria, Brazil, Peru, Kuwait, Tunisia, North Korea, United Arab Emirates, Argentina, Lithuania, Ethiopia, Mongolia, Russia, Kazakhstan, Belarus, Ukraine, Uzbekistan, Tajikistan, Bulgaria, Kyrgyzstan, Morocco, Cyprus, Hungary, Greece, Turkey, Egypt, Cuba, Romania, Spain, Italy, France, Poland, Vietnam, and Laos.

[12] According to Article 44 of Summary of Panel Discussion on Foreign-Related Commercial and Maritime Trial Work of Courts Nationwide (全国法院涉外商事海事审判工作座谈会会议纪要), issued by Supreme People's Court (最高人民法院) on December 31, 2021, if the laws of the foreign court where the judgment is issued stipulate that civil and commercial judgments made by courts in China can be recognized and enforced, then it is possible to deem that a reciprocal relationship exists between China and that country regarding the recognition and enforcement of civil and commercial judgments.

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foreign court judgments.[13] Based on searches conducted in several reputable legal databases in China, we found that most of these foreign court judgements related to divorce, and that during the period in question China's courts recognized very few foreign court commercial contract judgments.[14]

B. Recognition and Enforcement of Foreign Arbitration Awards in China

China is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"). Pursuant to the terms of the New York Convention, an arbitration award with respect to a commercial contract rendered in a member country can be enforced in China. Since almost all major North American, Latin American, European, Asian, and African countries are members to the New York Convention, commercial contract arbitration awards from such countries are generally enforceable in China. As a result, China courts are much more likely to recognize and enforce a foreign arbitration award than foreign court judgements.

Courts in China may, however, reject applications for recognition and enforcement of foreign arbitration awards under the New York Convection if:[15]

(i) the contact does not have a valid arbitration agreement between the parties;
(ii) the arbitration tribunal or the arbitration procedure was not conducted in accordance with the parties' contract or other legal requirements;
(iii) if the subject matter of the dispute is not governed under the arbitration agreement or is not arbitrable; or
(iv) the arbitral award conflicts with China's public policies.

Any rejection of an application for recognition and enforcement of a foreign arbitration award is subject to review by different levels of courts in China. If an Intermediate People's Court[16] wishes to reject an application for recognition or enforcement of a foreign arbitration award under the New York Convention, it must first report the case to the High People's Court for review. If the High People's Court agrees with the Intermediate People's Court's decision, it must report the case to the Supreme People's Court. Only after receiving approval from the

[13] "三年间，中国法院共予以承认和执行外国法院民商事判决案件 1142 件" (English translation: China Courts Recognized and Enforced a Total of 1142 Foreign Civil And Commercial Judgment Cases in Three Years), CHINANEWS.COM (OCTOBER 27, 2021)

[14] We searched the LexisNexis database of court decisions in China for the term "申请承认和执行", which term is normally used in the judgement of a title made by an Intermediate People's Court when enforcing a foreign court judgement. Using this procedure we found far fewer cases for the 2018 – 2020 period than quoted by Mr. Tao, but all of the cases we did find related to divorce. We found more cases when expanding the time period to 2010 – 2020, but very few of the cases related to commercial contracts. Although the databases are likely not comprehensive, they nonetheless suggest that the enforcement of foreign court commercial contract judgements in China is rare.

[15] See Article 290 of the China Civil Procedure Law and the Circular of the Supreme People's Court on Implementing the Convention on the Recognition and Enforcement of Foreign Arbitral Awards in China (最高人民法院关于执行我国加入的《承认及执行外国仲裁裁决公约》的通知), and Article V of the New York Convention.

[16] According to Article 290 of the China Civil Procedure Laws, the application for recognition and enforcement of a foreign arbitration award shall be submitted to the Intermediate People's Court of the place where the party subject to enforcement is domiciled or where its property is located.

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Supreme People's Court can the Intermediate People's Court reject the application.[17] This review process is designed to ensure that China's lower level courts comply with the New York Convention, and to help reduce the risk of local judicial protectionism. From 2015 to 2022, China's courts recognized and enforced a total of 95 foreign arbitration awards, and only rejected eight applications, thus reflecting a 92% enforcement rate.[18]

Given the tremendous uncertainty associated with recognizing and enforcing foreign court judgements in China, China's signatory status under the New York Convention, and a positive track record in enforcing foreign arbitration awards in China, foreign companies should generally choose foreign arbitration over foreign courts for resolving disputes under China commercial contracts.

V. Neutral Third Jurisdiction Arbitration

Although foreign companies generally prefer the governing law and dispute resolution mechanism of their home country, China companies often object based on many of the same potential disadvantages noted above. A common compromise is to use the law and dispute resolution mechanism of a neutral third jurisdiction. Because foreign court judgements from a third jurisdictions will face the same recognition and enforcement challenges in China as court judgements from the foreign company's home country, parties generally choose arbitration over courts. As noted above, this approach should also benefit the China company since the third jurisdiction arbitration award would also be enforceable against the foreign company if its home jurisdiction is also one of the 172 New York Convention parties.[19]

Hong Kong and Singapore are two of the most common choices for governing law and arbitration in China commercial contracts. In recent years, a growing number of foreign companies chose Singapore over Hong Kong due to concerns regarding the erosion of judicial independence and the rule of law in Hong Kong.[20] These concerns grew stronger on June 30, 2020, when Beijing implemented the Hong Kong National Security Law, which criminalized any act of succession, subversion or collusion with foreign or external forces, effectively bringing to an end street protests in Hong Kong that began a year earlier over a proposed extradition bill but quickly spread into a broader anti-China and pro-democracy movement.[21] For commercial disputes that do not involve political questions, however, the Hong Kong legal system continues to remain reliable, benefiting from sophisticated arbitration legislation, a strong and independent

[17] See Article 2 of the Circular of the Supreme People's Court on Issues Relating to the Handling Issues related to Foreign Arbitration and Foreign Arbitration Matters by the People's Courts (最高人民法院关于人民法院处理与涉外仲裁及外国仲裁事项有关问题的通知).

[18] See ZHANG YI AND ZHU ANRAN, 浅析外国仲裁裁决在中国的承认和执行 (English translation: Analysis of the Recognition and Enforcement of Foreign Arbitral Awards in China), LEXISNEXIS, (NOVEMBER 20, 2022).

[19] Contracting States, New York Arbitration Convention.

[20] In 2022, Hong Kong ranked 22nd in the Rule of Law Index issued by World Justice Project, falling from 19th in 2021 and 16th in each year from 2016 to 2020.

[21] The Laws of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region was issued by the National People's Congress of China on June 30, 2020 (the "Hong Kong National Security Law"). See BBC article "Hong Kong national security law: What is it and is it worrying?" for more information about the Hong Kong National Security Law.

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judiciary, premier arbitral institutions, a large pool of arbitration professionals, and a commitment to innovation.[22]

There isn't any substantial procedural difference associated with recognizing and enforcing arbitration awards from Singapore and Hong Kong in China. Singapore is a party to the New York Convention, and thus the recognition and enforcement of Singapore arbitration awards are subject to the general provisions that apply to other foreign arbitration awards when seeking enforcement in China.[23] Because Hong Kong is a part of China, enforcement of Hong Kong arbitration awards in China does not follow the normal New York Convention procedures. Instead, Hong Kong arbitration awards are subject to a special separate arrangement between Hong Kong and China, though in practices the differences are not material.[24]

Hong Kong does have one significant advantage over Singapore as a potential jurisdiction for the arbitration of disputes under China commercial contracts. Companies involved with an arbitration based in Hong Kong can apply directly to the mainland China courts for interim relief measures, such as evidence preservation or asset freeze orders.[25] Therefore, choosing Hong Kong over Singapore may still be a reasonable option if the parties anticipate that enforcement of an arbitration award in mainland China may be necessary.

VI. Additional Considerations.

Additional factors may also affect the parties' preferences for governing law and dispute resolution mechanism. For example, if a commercial contract is to be performed in China by a relatively small China company in a large city like Beijing or Shanghai, the risk of local court protectionism is lower than with a large China company in a smaller second or third tier city. In this context, choosing the laws of China and Beijing courts, Shanghai courts or arbitration in one of those cities, may be reasonable as this would simplify enforcement and might therefor lead to better compliance in the first instance or early settlement in the event of a dispute.

In our experience, many large China companies that regularly transact with foreign companies and thus tend to place more value on their international reputation, are more likely to voluntarily comply with foreign arbitration awards, thereby avoiding the need to enforce the award in China's courts. In addition, many large China companies have foreign subsidiaries that hold material foreign assets. Depending on the relative negotiating strength of each party, a foreign company may be able to obtain a performance guarantee from a material foreign affiliate of the China party. In such a situation, using the law and dispute resolution mechanism of the

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[22] "The Strong Foundations On Which Hong Kong's Status As A Leading Seat Of International Arbitration Rests Remain Intact", HONG KONG LAWYER (APRIL, 2021).

[23] See China's Civil Procedures Laws and the Circular of the Supreme People's Court on Implementing the Convention on the Recognition and Enforcement of Foreign Arbitral Awards in China (最高人民法院关于执行我国加入的《承认及执行外国仲裁裁决公约》的通知).

[24] See the Arrangement of the Supreme People's Court on Reciprocal Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region (最高人民法院关于内地与香港特别行政区相互执行仲裁裁决的安排) effective on February 1, 2000 and as amended on November 26, 2020.

[25] See the Arrangement Concerning Mutual Assistance in Court-ordered Interim Measures in Aid of Arbitral Proceedings between mainland China and Hong Kong (关于内地与香港法院就仲裁程序互相协助保全的安排), effective on October 1, 2019.

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jurisdiction where the China company's foreign affiliate is located could facilitate enforcement of damage awards without ever engaging with China's courts.

VII. Governing Law and Dispute Resolution Rules of Thumb

Although each situation will have its own unique circumstances to consider, we have summarized general "rules of thumb" that we consider when choosing the governing law and dispute resolution jurisdiction for a foreign company client in a China commercial contract.

(i) Align Law and Venue. Align the governing law jurisdiction with the dispute resolution venue: Hong Kong and Hong Kong, Singapore and Singapore – don't mix and match.

(ii) Foreign Law. In most instances, a foreign company should push to use the law of its home country or a "neutral" third country or jurisdiction. Hong Kong and Singapore are the most common third jurisdiction choices.

(iii) Foreign Arbitration. For contracts governed by a foreign law, choose arbitration over courts.

(iv) China Laws, China Arbitration. For contracts governed by the laws of China, choose arbitration in a large city in China over China's court, preferably in a city other than the one where the China party is headquartered or has material operations.

(v) Foreign Subsidiary Guarantee. If a China company's foreign affiliate with material assets provides a performance guarantee, choose the law of and arbitration in the jurisdiction of that foreign affiliate or where its material assets are located.

(vi) Small China Companies in Big Cities. If the China company is small but located in a large city like Beijing or Shanghai, consider using the laws of China and either the courts of the large city or arbitration in that city.

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