China Law Update

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Strategy for Foreign Companies' Purchase Transactions in China During Financial Crisis

Due to the global financial crisis and economic downturn, foreign companies are faced with more challenges and risks associated with international purchase transactions with Chinese suppliers. As a result, it is suggested that foreign companies take steps to reduce costs and control risks when purchasing commodities in China.

Choosing the Best Supplier

A significant number of domestic manufacturing businesses in China were profoundly affected in the global financial crisis. These businesses are faced with fierce competition and their profit margin has decreased dramatically, not to mention the factories that were shut down as a result of the economic downturn. As a result, foreign companies will exercise more caution in choosing the Chinese suppliers they do business with amid the financial crisis.

Foreign companies are advised to perform effective quality control and due diligence on the products and manufacturers, even for suppliers with which the company has past dealings. If the supplier is a domestic company, the focus of the due diligence is whether the supplier has sufficient foreign trade experience and valid exporting licenses and permits. If the supplier has foreign investment involved or is a wholly foreign owned enterprise, attention should be paid to intellectual property issues relating to the purchased products. Recent cases indicate that some foreign companies got involved in intellectual property disputes because the sales and purchase agreement failed to explicitly specify ownership of the intellectual property rights associated with the purchased products.

Signing a Complete Contract

It is generally known that foreign companies usually purchase commodities in China by signing a standard purchase order with Chinese suppliers. Besides the purchase order, there is not any other written contract governing the transaction. The absence or vagueness of the terms and conditions of the transaction are likely to cause potential problems in contract disputes.

In order to avoid the risks of contract disputes, an international purchase contract should be composed of two parts: a master purchase agreement and the purchase orders. The master purchase agreement specifically provides the rights and obligations of each party to the purchase transaction. The purchase order should only indicate commercial terms (i.e., name, type and quantity of goods; lead time; place and date of delivery) for that particular transaction. In this manner, the combination of a master purchase agreement and a purchase order constitutes a complete contract between the foreign purchaser and the Chinese supplier.1[1]

Selecting Dispute Resolution Mechanism

According to the Contract Law of the People's Republic of China2[2], parties to a foreign-related contract may choose the law to be applied in case of business disputes, which means the law of a jurisdiction outside Mainland China could be applied in international sales transaction in China. However, even though the contract stipulates that foreign law governs, it does not ensure that foreign companies will be able to successfully control their legal risks. Specifying the governing law of the purchase contract is only one of the legal risk control strategies.3[3]

Compared to litigation, arbitration is a better choice of dispute resolution for foreign companies for the following reasons:

1. Arbitration awards can be recognized and enforced by Chinese courts4[4], while foreign court judgments may not be recognized by Chinese courts due to the lack of bilateral treaties for the recognition of foreign court judgments between China and other counties;

2. Compared to prolonged litigation procedures in China, arbitration is much more efficient and can save time for each party;

3. In respect to protecting the business information of each party, arbitration is better than litigation, which is often heard publicly in court.

Monitoring Domestic Trade Policies

In recent years, due to the increased costs of raw materials and labor in China, as well as the appreciation of RMB, the cost advantage of Chinese suppliers has diminished. Therefore, some foreign companies began to turn their eyes to countries with even lower manufacturing costs such as India, Vietnam and North Korea.

Aiming at reviving foreign trade, Chinese government has announced that it would strengthen the cross-departmental cooperation among the administrations of commerce, the administration of Customs and administration of quality supervision, inspection and quarantine, thereby creating a favorable environment for foreign trade. In order to maximize their interests, foreign companies should keep a close eye on and take advantage of related foreign trade policies and measures promulgated by the Chinese government.

Conclusion

In order to minimize the risks associated with purchase transactions in China during this financial crisis, foreign companies should adopt various strategies including careful selection of suppliers, documentation of transactions, adopting efficient dispute resolution mechanisms and monitoring domestic trade policies.

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5[1] *See*, Ken Huang, Risk Control in International Sale and Purchase Transactions with Chinese Suppliers

6[2] Article 126 of the Contract Law states that "parties to a foreign-related contract may select the applicable law for resolution of a contractual dispute, except as otherwise provided by law. Where parties to the foreign-related contract fail to select the applicable law, the contract shall be governed by the law of the country with the closest connection thereto."

7[3] *See*, Ken Huang, Risk Control in International Sale and Purchase Transactions with Chinese Suppliers

8[4] China and many developed countries are members of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.