Whitepaper
China’s Derivatives Market and Judicial Trends
INTRODUCTION

Foreign banks have traded over-the-counter (OTC) derivatives with Chinese counterparties for many years, and the Chinese government has taken significant steps to further open up its financial markets and financial sector to foreign participants. The Belt and Road initiative has encouraged Chinese counterparties to use various forms of financing and derivative structures in China1,2.

With ever-increasing foreign participation in China’s derivatives market, disputes arising from derivative transactions have increased in recent years, particularly following the 2008 financial crisis.

This paper examines recent Chinese cases and arbitration decisions, and the rationale for their decisions. It analyzes the latest judicial trends relating to derivatives disputes in China, and how these trends may impact the judiciary’s interpretation of provisions in the ISDA Master Agreement. It also examines the key issues faced by banks when disputes arise with Chinese counterparties, and provides practical insights on the approaches likely to be adopted by courts and arbitrators in China when hearing derivative-related disputes3.

Jurisdiction issues under Chinese law are complicated. This paper also examines jurisdiction and enforcement of transactions involving Chinese parties. Information about the Chinese court cases and arbitration decisions referred to in this paper is summarized in the Chinese case Summaries section.

China is a civil law jurisdiction and so does not recognize cases as binding precedents. Therefore, the cases examined in this paper do not constitute law in China and are not binding. However, judges are increasingly willing to look at previous cases even if they are not a formal source of law, in particular for disputes involving complex or innovative financial transactions.

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1 The National Development and Reform Commission reported in March 2017 that ‘Office figures indicate that the direct investment by China exceeded $50 billion in Belt and Road countries from 2013 to 2016’
2 In October 2017, the SAFE expressed its intention for domestic Chinese enterprises to use derivatives for FX hedging purposes, as stated in SAFE Questions and Answers on the Status Quo on Foreign Exchanges in Q3 2017 (October 1, 2017)
3 This paper has drawn references from reported Chinese cases listed in the section in this paper headed ‘Chinese Case Summaries’ and King & Wood Mallesons’s general experience in advising and representing parties involved in disputes with respect to financial derivative contracts submitted for arbitration before the China International Economic and Trade Arbitration Commission (CIETAC) and other Chinese arbitration institutions
The Supreme People’s Court (SPC) introduced a guiding case system in November 2010, which is known as China’s ‘case law’. The guiding case system helps to achieve greater consistency among lower courts. It introduces de facto binding cases, requires courts at all levels to take into account the guiding cases published by the SPC when hearing similar cases, and requires relevant cases to be quoted with the reasons for a judgment, but not as a basis for the judgment.

The SPC has not yet published any guiding cases involving derivatives disputes.

Disputes arising from derivative contracts can be categorized into three broad categories:

- jurisdiction and enforcement related issues;
- formation, validity and enforceability of the derivative contracts; and
- mis-selling claims against banks.

Each of those issues is analyzed in a particular section of this paper, and summaries of that analysis appear throughout. Meanings of terminology used in this paper are set out in the Glossary section.

DISCLAIMER

This paper does not purport, and should not be considered, to be a guide or explanation of all relevant issues or considerations in a particular transaction or contractual relationship. Parties should therefore consult their legal advisers and any other adviser they deem appropriate when considering this paper.

This paper does not constitute legal advice. Neither ISDA nor King & Wood Mallesons assumes any responsibility for any use of, or reliance on, this paper.

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4 See, for example, ‘Chinese Common Law? Guiding Cases and Judicial Reform’, 129 Harv. L. Rev 2213.
5 Article 7 of the Provisions of the Supreme People’s Court on Case Guidance Work issued by the SPC on November 26, 2010
6 Article 9 and 10 of the Detailed Rules on Implementing the Provisions of the Supreme People’s Court on Case Guidance Work issued by the SPC on May 13, 2015
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JUDICIAL TRENDS IN DERIVATIVE-RELATED DISPUTES

JUDICIAL TRENDS IN CHINESE COUNTERPARTY DISPUTES

Parties Involved

Reported Chinese cases arising from derivative transactions may generally be categorized as either:

- Onshore disputes – disputes about OTC derivative transactions between a Chinese corporate and a Chinese bank (or a foreign bank’s local presence or onshore branch); or
- Cross-border disputes – disputes about OTC derivative transactions between a Chinese corporate or individual (or the overseas affiliate of a Chinese group) and a foreign bank.

Most of the reported cases relate to onshore disputes only. It is expected that cross-border disputes will increase in response to transactions relating to the Belt and Road initiative that involves foreign banks and the offshore investment vehicles of Chinese corporates.

Key Issues

Claims raised by a defaulting party commonly involve the following questions:

- In the context of a cross-border dispute, whether the parties are bound by a foreign jurisdiction clause, and whether the Chinese courts have jurisdiction to hear the dispute;
- Whether a transaction has been concluded, and which document(s) constitute the contract or agreement relating to a particular transaction, including:
  - Whether a contract has been concluded under Chinese law and whether the parties have agreed that all transactions constitute a ‘single agreement’;
  - Which document(s) constitute the transaction document(s) and what is their legal effect;
  - What are the risks associated with material deviations from standardized industry documentation; and
  - Is there a lack of authorisation for the relevant representatives of the counterparty to trade in derivative transactions;
- Whether the agreements for a transaction are invalid due to:
  - The speculative nature of the transaction (for example, a gambling contract) with unfair terms;
  - A lack of capacity of the counterparty to enter into the transaction;
  - A recharacterisation of the legal nature of the derivative contract; or
  - A failure by an onshore bank to comply with the regulatory requirements applicable to banks in respect of derivative transactions;

7 In a cross-border transaction, the onshore branch or subsidiary of a foreign bank in China is sometimes involved in the initial client origination and introduction, whilst the transactions are booked to the foreign bank’s head office or its offshore affiliate and transacted outside China.
• Whether the relevant early termination amount/mechanism is not enforceable due to:
  o The application of a statutory restriction on the quantum of ‘liquidated damages’ under the Chinese Contract Law;
  o A lack of performance by the parties under a transaction; or
  o Unfair determination of an early termination amount or other valuation;

• Whether there exists any fraud or misconduct by the bank during the contract negotiation process.

This paper examines each of those issues, followed by an analysis of the general views and positions of Chinese courts and arbitral tribunals with respect to the relevant legal issues under Chinese law.
JURISDICTION AND ENFORCEMENT

JURISDICTION ISSUES FOR CROSS-BORDER DISPUTES

Jurisdiction is a complicated legal issue in China. Foreign exchange controls mean that only a few types of Chinese financial institutions, such as domestic banks, insurance companies, securities companies and qualified domestic institutional investors (QDIIs) or state-owned enterprises (SOEs), are permitted to trade derivatives on a cross-border basis with foreign banks.

Chinese parties (that, for the purpose of this paper, include the overseas affiliated entities of a Chinese incorporated entity) usually prefer to submit disputes to Chinese courts or arbitral tribunals (due to their perception of high legal costs associated with foreign judicial proceedings and their lack of familiarity with foreign procedures), while foreign banks prefer to submit disputes to English or New York courts or foreign arbitral tribunals.

Irrespective of whether a foreign jurisdiction clause or foreign arbitration clause is agreed, a Chinese counterparty will often seek to have a cross-border dispute heard in a Chinese court.

The effect of a valid foreign jurisdiction clause in a cross-border transaction and its limitations are examined later in this paper.

Summary

A foreign bank that wants to resolve potential cross-border disputes relating to its derivative contract with a Chinese counterparty in a foreign forum should:

• Agree on the foreign governing law and exclusive foreign jurisdiction clause;
• Select a foreign jurisdiction that has a ‘connection’ with the parties or the subject matter of the contract;
• Ensure the exclusive foreign jurisdiction clause is clearly drafted to cover contractual claims, related tortious and other non-contractual claims; and
• Ensure the exclusive foreign jurisdiction clause covers all related affiliates of the foreign bank.

Foreign Jurisdiction Clauses Under Chinese Law

How does a Chinese court interpret the validity of a submission to a foreign jurisdiction in judicial proceedings initiated in China?

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8 There are specific licence or other regulatory requirements applicable to each type of Chinese entities’ cross-border derivative transactions. These requirements are not covered in this paper.

9 The term ‘judicial proceeding’ here means a court trial case initiated in China, but not a court case initiated to enforce a foreign judgment or arbitration award in China.
The Law That Determines The Validity Of Foreign Jurisdiction Clause

Under the Chinese Contract Law and the Chinese Foreign Relationships Application Law, parties to a contract with a ‘foreign element’\(^\text{10}\) can contractually agree to adopt foreign law as the governing law for their contract unless:

- The choice of foreign law is expressly prohibited by Chinese law\(^\text{11}\); or
- Chinese law provides for ‘mandatory requirements’ applicable to a foreign-related civil relationship, in which case the mandatory requirements under Chinese law apply directly regardless of the parties’ choice of governing law\(^\text{12}\).

The parties’ choice of foreign law, for example New York, Hong Kong or English law, as the governing law for a cross-border derivative contract is valid and enforceable. The choice of foreign law does not contravene any ‘mandatory requirements’ under Chinese law.

In interpreting what constitutes ‘mandatory requirements’, the SPC has provided a list of circumstances to which Chinese law applies mandatorily\(^\text{13}\). Privately negotiated derivative transactions under an ISDA Master Agreement fall outside such restricted circumstances\(^\text{14}\).

However, when a cross-border dispute is submitted to the Chinese court, the court does not use the chosen governing law to determine whether the jurisdiction clause is valid. Instead, Chinese courts generally consider all issues relating to the validity of a jurisdiction clause as a procedural matter that is subject to *lex fori* (ie, the laws of the jurisdiction in which a legal action is brought should apply\(^\text{15}\)). Chinese courts will apply Chinese law to determine the validity of the jurisdiction clause (irrespective of the chosen governing law of the contract).

That principle does not apply to arbitration provisions involving a foreign element. Under the Chinese Foreign Relationships Application Law, the law chosen by the contracting parties as the governing law for the arbitration proceedings (not a general governing law clause for the contract) will prevail for the purpose of determining the validity of an arbitration clause.

**Summary**

The validity of a foreign jurisdiction clause will be determined by Chinese law but the submission to a foreign arbitration is not necessarily subject to review by Chinese courts.

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\(^{10}\) According to the definition under the Foreign Relationship Application Law Interpretation (I), any of the following circumstances constitutes a ‘foreign element’: any or both of the parties are foreign citizens, foreign corporates or organisations, or stateless persons; any or both of the parties are domiciled outside China; the subject of the contract is located outside China; the facts that give rise to the creation, alteration and termination of the legal relations occur outside China; and other circumstances that could be regarded as having a foreign element.

\(^{11}\) Article 126 of the Chinese Contract Law

\(^{12}\) Article 4 of the Chinese Foreign Relationships Application Law

\(^{13}\) Article 10 of the Foreign Relationships Application Law Interpretation (I)

\(^{14}\) The circumstances where Chinese law mandatorily applies regardless of the parties’ agreement include: protection of employees’ benefits; food safety or public health and safety; environmental safety; foreign exchange control and other financial safety; anti-trust; and other circumstances where Chinese law shall mandatorily apply.

\(^{15}\) Dicey, Morris & Collins on the Conflicts of Laws 15th Ed., Volume 1, Part 2, Chapter 7, Para 7R-001
Use Of Foreign Jurisdiction Clause In ‘Foreign-Related’ Derivative Contracts

Article 531 of the Civil Procedures Law Interpretation allows parties to a dispute involving a contract with a ‘foreign element’ (or a dispute involving a foreign right or an interest in property) to submit a dispute to a foreign court in a jurisdiction that is in the place:

- Of domicile of the plaintiff or the defendant;
- Where the contract is performed or signed;
- Where the subject matter is located;
- Where the infringement occurred; or
- With some other ‘actual connection’ with such dispute\(^{16}\).

However, the parties cannot agree to submit a dispute to a court in a foreign jurisdiction in certain exceptional scenarios\(^{17}\). Cross-border derivative contracts should generally fall outside those exceptions.

Accordingly, the parties to a ‘foreign-related’ derivative contract may adopt a foreign jurisdiction clause and submit their disputes to a foreign court with the prescribed ‘actual connection’ with the dispute (ie, the factors listed immediately above).

Actual Connection Rule – Foreign Jurisdiction Clauses

If the parties agree to submit their dispute to a foreign court in a place that, in the opinion of a Chinese court, has no ‘actual connection’ with the dispute, the Chinese court is likely to decide that the foreign jurisdiction clause is invalid. The Chinese court will then determine whether it has jurisdiction to continue hearing the substantive dispute (ie, not just the procedural issue relating to the validity of the parties’ choice of jurisdiction).

On September 12, 2017, China signed the Hague Convention of June 30, 2005 on Choice of Court Agreements. Article 19 (Declarations limiting jurisdiction) of the Hague Convention allows the parties to agree to use a court without an ‘actual connection’ (that is, a ‘disinterested court’). Although China is a signatory to the Hague Convention, it is anticipated that the Chinese government will still apply the principle of ‘actual connection’ in implementing the Hague Convention in order to minimize its conflict with the current Chinese civil procedure. China has not yet ratified the Hague Convention\(^{18,19}\).

\(^{16}\) Although Article 531 of the Civil Procedures Law Interpretation does not apply to the choice of foreign arbitration, an agreement to submit non-foreign-related disputes to foreign arbitration is invalid.

\(^{17}\) The exceptional scenarios where the dispute involves matters that are subject to the exclusive jurisdiction of the Chinese courts under Articles 33 and 266 of the Chinese Civil Procedures Law, include: in the case of a real estate dispute lawsuit, the Chinese court at the location of the real estate shall have exclusive jurisdiction; in the case of a lawsuit regarding a dispute arising in port operations, the Chinese court at the location of the port shall have exclusive jurisdiction; in the case of an inheritance dispute lawsuit, the Chinese court at the decedent’s domicile at the time of death or the location of the main legacy shall have exclusive jurisdiction; in the case of a lawsuit filed for disputes arising from performance of Sino-foreign equity joint venture enterprise contract, Sino-foreign cooperative joint venture enterprise contract, Sino-foreign cooperative exploration and exploitation of natural resources contract in China, the Chinese courts shall have exclusive jurisdiction.

\(^{18}\) Pursuant to the Law on Procedures for Concluding a Treaty of the People’s Republic of China, the Hague Convention still needs the approval by the National People’s Congress. After approval, the Ministry of Foreign Affairs will notify its intention to join the Hague Convention. The Hague Convention will then be effective in China in 3 months after the submission.

\(^{19}\) See the article entitled ‘The Choice of Court Agreement and Its Implications on China’ written by Mr James Guan, a partner of the Dispute Resolution team of KWM in China, for further explanation about this issue.
Citic Aus Case – Actual Connection Rule In The Choice Of Foreign Court

Shanxi Coal Import & Export Co. Ltd. (Shanxi Coal) submitted a contractual dispute to the Shanxi High People’s Court against CITIC Australia Commodity Trading Pty Limited (CITIC AUS). CITIC AUS challenged the jurisdiction of the Shanxi High Court, alleging that the parties agreed to submit the dispute to the exclusive jurisdiction of the High Court of London. Shanxi High Court dismissed CITIC AUS’ challenge on the basis that the objection period had expired. CITIC AUS lodged an appeal to the SPC.

The SPC held that the challenge was made within the objection period, but the exclusive jurisdiction clause was not valid under Chinese law because the dispute had no actual connection with London.

Court Jurisdiction Certainty Rule Applies To Chinese Jurisdiction Clauses

A Chinese jurisdiction clause (where the parties agree to submit their disputes to the jurisdiction of a Chinese court, whether in an onshore dispute or cross-border dispute), must specify the precise location of the court that is to determine any dispute, with a degree of certainty. This is generally known as the ‘court jurisdiction certainty rule’.

The parties may provide for a specific court (such as Shanghai Pudong New Area People’s Court) or a specific location (such as the location of a contracting party). The court jurisdiction certainty rule is construed strictly for all agreements that submit to the jurisdiction of a Chinese court.

Does That Same Rule Apply To Foreign Jurisdiction Clauses?

In the case of contracts that specify a foreign jurisdiction clause, specification of the relevant foreign jurisdiction is generally acceptable. For example, a foreign jurisdiction clause providing for the ‘courts of Hong Kong’ or the ‘courts in England’ will satisfy the court jurisdiction certainty rule.

Xu Zhiming Case – Court Jurisdiction Certainty Rule

The Xu Zhiming case upheld the principle that where parties agree to submit their disputes to foreign courts, they need only specify the country in which the court is located instead of a specific court in that country – so long as the actual court can be determined pursuant to the laws of that country. In the Xu Zhiming case, Mongolia is the place where the contract was executed and performed and so the place with actual connection with the dispute. The agreement to submit to Mongolian courts was therefore sufficiently specific to be upheld under the Chinese civil procedural law principles.
Summary

The parties to a derivative contract with a ‘foreign element’ may only agree to submit disputes to a foreign court in a jurisdiction with an ‘actual connection’.

The parties need not follow the usual Chinese rule on certainty of court jurisdiction that a specific court is chosen to hear disputes.

Exclusive And Non-Exclusive Jurisdiction Clauses Under Chinese Law

The general position under Chinese law is that:

- Non-exclusive jurisdiction: a non-exclusive foreign jurisdiction clause in a ‘foreign-related’ derivative contract with a ‘foreign element’ should not preclude courts in other jurisdictions from having jurisdiction over the dispute.

A non-exclusive foreign jurisdiction clause may not therefore preclude the Chinese courts’ jurisdiction. This means a party may choose to initiate the proceedings in a Chinese court (for example, where the other party has property in China). The defendant may challenge the jurisdiction of the Chinese court based on a doctrine such as forum non conveniens (ie, another forum may be more appropriate).

The doctrine of forum non conveniens is recognized in Article 532 of the Civil Procedures Law Interpretation, which provides that a Chinese court must be satisfied that each of the following conditions is met (the ‘six-condition test’) before it declines jurisdiction and directs the claimant to a more convenient foreign court:

- The defendant requests that the proceedings be brought in a convenient foreign court or challenges the jurisdiction of the Chinese courts;

- There is no agreement between the parties to submit the disputes to Chinese courts;

- The case is not one of a type that is subject to the exclusive jurisdiction of the Chinese courts;

- The case is not related to the interests of the state, citizens, corporations or other organisations of China:

- The majority of facts relating to the dispute occurred outside China, Chinese law does not apply, and therefore the Chinese courts may have material difficulty in deciding the facts or applying the relevant law when hearing the case; and

- The foreign court has jurisdiction over the dispute and is a convenient forum to hear the dispute.

The On Hing Paper case and the Brightfood case demonstrate the difficulty in running a ‘forum non conveniens’ argument.

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21 Article 12 of the Foreign Elements Cases Circular
22 Dicey, Morris & Collins on the Conflicts of Laws 15th Ed., Volume 1, Part 3, Chapter 12, Para 12-007
**On Hing Paper Case**

The parties to a derivative contract were Hong Kong entities. Irrespective of an agreed (non-exclusive) foreign jurisdiction clause, Fubon Bank commenced proceedings against On Hing Paper in the Shenzhen Qianhai Cooperation Zone People’s Court.

The defendant applied to set aside the Chinese proceedings alleging that the Chinese court was an inconvenient forum having no jurisdiction over the dispute. The trial court and the intermediate court at a higher level dismissed the defendant’s application on the basis that the courts had no material difficulty in finding and applying Hong Kong law when hearing the case (in other words, not each and every condition for the Chinese court to decline jurisdiction as set out in Article 532 of the Civil Procedures Law Interpretation was satisfied).

**Brightfood Case**

Brightfood Hong Kong Limited (Brightfood) entered into a 2002 ISDA Master Agreement with Deutsche Bank AG (DB) in September 2013, as well as various cross-currency swaps through DB’s Hong Kong Branch (DB HK Branch) in 2013 and 2014. Some of the swaps in 2014 were introduced by Deutsche Bank (China) Co., Limited, Shanghai Branch (DB (China) SH Branch) to DB HK Branch.

In 2016, Brightfood filed a claim with the Shanghai No. 1 Intermediate People’s Court to invalidate the cross-currency swaps entered into in 2014 on the ground that they were mis-sold to Brightfood.

The defendants, DB, DB HK Branch and DB (China) SH Branch, unsuccessfully challenged the jurisdiction of the Shanghai court on the ground of *forum non conveniens*.

The Chinese courts held that:

- The non-exclusive jurisdiction clause under the 2002 ISDA Master Agreement did not preclude Brightfood from filing a lawsuit in China;

- Although DB (China) SH Branch was not a party to the ISDA agreement or swaps, DB had a representative office in Shanghai, establishing a competent jurisdiction for the Shanghai courts to hear the case; and

- Brightfood’s onshore parent’s interest was very likely to be involved in the dispute (which means the ‘six-condition test’ set out in Article 532 of the Civil Procedures Law Interpretation had not been satisfied), so DB’s challenge to the Chinese court’s jurisdiction on the basis of *forum non conveniens* was dismissed.
Exclusive jurisdiction: An exclusive foreign jurisdiction clause is intended to preclude other courts from having jurisdiction over the dispute. If the jurisdiction clause does not use the term ‘non-exclusive’, it will generally be held by a Chinese court as an ‘exclusive jurisdiction’ clause. This practice in China aligns generally with a Hague Convention principle that ‘a choice of court agreement which designates the courts of one Contracting State or one or more specific courts of one Contracting State shall be deemed to be exclusive unless the parties have expressly provided otherwise’.

Xu Zhiming Case – Exclusive Jurisdiction

The Xu Zhiming case decided that if the jurisdiction clause does not have the wording ‘non-exclusive’, it will be treated as an ‘exclusive jurisdiction’ clause.

Summary

A Chinese court will only decline jurisdiction in respect of a non-exclusive jurisdiction clause for forum non conveniens where all of the conditions set out in Article 532 of the Civil Procedures Law Interpretation are met.

An exclusive jurisdiction clause is usually binding in China unless the chosen forum is considered by a Chinese court not to have an actual connection with the dispute.

A description of the exclusive foreign jurisdiction clause is provided below.

Effect Of An Exclusive Foreign Jurisdiction Clause

Generally, an exclusive foreign jurisdiction clause is binding on a Chinese counterparty. But a Chinese party may still attempt to commence a claim in the Chinese courts, as illustrated in the following cases.

Non-Contractual Claims Arising From The Derivative Contract

A Chinese party may allege that a particular exclusive foreign jurisdiction clause only covers contractual claims, but does not extend to tortious claims (for example, tortious allegations of mis-selling activities).

The Lai Jianping case held that a Chinese court will apply exclusive jurisdiction clauses in the context of non-contractual claims.

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23 For example, in the jurisdiction clause specified in the 2002 ISDA Master Agreement, ‘Proceedings’ means ‘any suit, action or proceedings relating to any dispute arising out of or in connection with’ the agreement.
Lai Jianping Case

Mr Lai commenced proceedings in China against a foreign bank for tort, alleging that the foreign bank had engaged in a fraudulent sale, wrongful disposition and conversion of his property. Mr Lai argued that the Chinese courts should have jurisdiction because his claim arose from the tortious acts of the foreign bank in its selling activities, rather than from a breach of contract.

The Shanghai High People's Court disagreed, deciding that the foreign jurisdiction clause is valid to confer on the Hong Kong courts' exclusive jurisdiction over Mr Lai's claim. The Shanghai High Court dismissed the tort claim arising from the master agreement, and held that regardless of whether Mr Lai's claim was based in contract or in tort, it would necessarily involve the adjudication of the effect and performance of the master agreement that, in accordance with the foreign jurisdiction clause, was a matter for the Hong Kong courts to decide. That decision was affirmed by the SPC in 2012 when Mr Lai applied for a retrial.

The Lai Jianping case demonstrates that the Chinese courts may interpret an exclusive jurisdiction clause widely to cover not only contractual claims but also tortious claims as long as the clause is drafted broadly enough to cover any proceedings 'relating to any disputes arising out of or in connection with' the derivative contract.

Chinese judicial practice also recognizes the effectiveness of an asymmetrical clause (under which a bank may submit any dispute to a jurisdiction of its choice whereas the counterparty's choice of jurisdiction is limited to a particular jurisdiction)24. The Lai Jianping case upheld an asymmetrical jurisdiction clause.

An Exclusive Jurisdiction Clause May Not Bind A Third Party

Notwithstanding the parties agreeing to an exclusive jurisdiction clause, a Chinese party may join a third party affiliate of a foreign bank (which is not a party to the contract but is involved in the selling process) as a party to its claim against the foreign bank. An exclusive jurisdiction clause only binds the contracting parties, but not a third party affiliate. This issue was considered in the Haisheng Juice case (an English case)25.

Haisheng Juice Case

China Haisheng Juice Holdings Co., Ltd. (a Cayman Islands company listed on The Hong Kong Stock Exchange, Haisheng Juice) entered into an ISDA 2002 Master Agreement (which included an exclusive jurisdiction clause) with Morgan Stanley Co. International Plc (MSIP), and executed a currency swap transaction. Haisheng Juice failed to post collateral under the currency swap transaction and commenced an action for tort before the Xi'an Intermediate People's Court seeking an order to set aside the ISDA Master Agreement and claiming damages from MSIP and Morgan Stanley Asia Limited (MSAL, an entity involved in the selling process but not a party to the ISDA agreement). The Chinese court accepted Haisheng Juice's petition.

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24 On the basis that derivative contracts are concluded by parties of equal negotiating power, scenarios that invalidate unfair and unreasonable clauses have not been considered.

MSIP initiated proceedings in England claiming sums due under the ISDA Master Agreement and seeking an anti-suit injunction against Haisheng Juice to the effect that all claims against MSIP and MSAL should be brought in England in reliance on the foreign exclusive jurisdiction clause. Haisheng Juice accepted that it could not prevent MSIP from pursuing its claim for sums due under the ISDA Master Agreement in England. However, it argued that the exclusive jurisdiction clause only extended to the claims it had brought against MSIP and did not extend to the claims against MSAL.

The English Commercial Court considered whether the exclusive jurisdiction clause would reasonably be understood to mean that MSIP and Haisheng Juice promised each other that claims arising out of or in connection with the ISDA Master Agreement would be brought in England ‘regardless of whether the claims were against the other or a non-party to the Master Agreement’.

The court held that the exclusive foreign jurisdiction clause applied only to claims between the contracting parties to the ISDA Master Agreement (ie, Haisheng Juice and MSIP), and granted an anti-suit injunction so that all claims and counterclaims concerning MSIP would be heard in England. The court also held that the exclusive foreign jurisdiction clause did not apply to disputes brought against third parties, such as MSAL and as such, Haisheng Juice could not be restrained from pursuing those claims in China.

This case was later settled before the commencement of the proceedings in the Xi’an Intermediate People’s Court.

26 Section 13 of the 2002 ISDA Master Agreement between Haisheng Juice and MSIP as amended by the Schedule provided that:

‘(a) Governing Law. This Agreement will be governed by and construed in accordance with the laws of England and Wales.

(b) Jurisdiction and Third Party Rights.

(i) Jurisdiction. With respect to any suit, action or proceedings relating to any dispute arising out of or in connection with this Agreement (‘Proceedings’), each party:

(1) irrevocably submits to the exclusive jurisdiction of the English courts; and

(2) waives any objection that it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have any jurisdiction over such party.

(ii) Third Party Rights

(1) Subject to this clause, a person who is not a party to this Agreement has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce any term of this Agreement.

(2) Notwithstanding the foregoing, an Affiliate may enforce the rights expressly granted to an Affiliate under this Agreement, if any, subject to and in accordance with this clause, Section 13(a) and (b) of this Agreement and the provisions of the Contracts (Rights of Third Parties) Act 1999. However, such an Affiliate may not bring proceedings to enforce any of those terms unless it has first given written notice to the parties (in accordance with Section 12 of this Agreement) agreeing to the provisions of Section 13 of this Agreement. The parties to this Agreement do not require the consent of any Affiliate or other third party to rescind or vary this Agreement.

(c) Service of Process. Each party irrevocably appoints the Process Agent, if any, specified opposite its name in the Schedule to receive, for it and on its behalf, service of process in any Proceedings. If for any reason any party’s Process Agent is unable to act as such, party will promptly notify the other party and within 30 days appoint a substitute process agent acceptable to the other party. The parties irrevocably consent to service of process given in the manner provided for notices in Section 12(a)(i), 12(a)(ii) or 12(a)(vi). Nothing in this Agreement will affect the right of either party to serve process in any other manner permitted by applicable law.

(d) Waiver of Immunities. Each party irrevocably waives, to the extent permitted by applicable law, with respect to itself and its revenues and assets (irrespective of their use or intended use), all immunity on the grounds of sovereignty or other similar grounds from (i) suit, (ii) jurisdiction of any court, (iii) relief by way of injunction or order for specific performance or recovery of property, (iv) attachment of its assets (whether before or after judgment) and (v) execution or enforcement of any judgment to which it or its revenues or assets might otherwise be entitled in any Proceedings in the courts of any jurisdiction and irrevocably agrees, to the extent permitted by applicable law, that it will not claim any such immunity in any Proceedings.

27 After examining Section 13 of the ISDA Master Agreement (as amended by the relevant Schedule), the English court concluded that the reference to Affiliates in Clause 13(b)(ii) only deals with claims brought by MSIP’s affiliate ‘where the affiliate wishes to exercise a right expressly granted to it under the Agreement’. It did not deal with claims brought against an affiliate of MSIP such as MSAL.
The Haisheng Juice case highlights the potential risk that an exclusive foreign jurisdiction clause may not be effective in precluding a Chinese party from commencing parallel proceedings in the Chinese courts against a counterparty and a third party as co-defendants.

**Summary**

An exclusive jurisdiction clause should be drafted so that it applies to:

- All matters arising out of or in connection with a derivative contract (including, for example, any act arising out of tort); and
- Any affiliate of the bank that might possibly be sued by a Chinese counterparty.
JURISDICTION ISSUES FOR ONSHORE DISPUTES

Onshore Jurisdiction Clauses

Disputes arising from, or in connection with, contracts concluded between two Chinese parties are required to be submitted to the jurisdiction of Chinese courts or arbitration administered by a domestic arbitration institution.

For example, the National Association of Financial Market Institutional Investors (NAFMII) master agreement that the People’s Bank of China has mandated for certain types of transactions entered into by participants of China’s inter-bank market provides that disputes should be submitted to the jurisdiction of a Chinese court or the China International Economic and Trade Arbitration Commission (CIETAC) Beijing for arbitration.

Article 124(2) of the Chinese Civil Procedures Law prohibits parties from commencing actions in the Chinese courts in respect of disputes where the parties have agreed on a valid arbitration clause.

In comparison with court proceedings, parties to arbitral proceedings may benefit from the confidentiality and finality of arbitration awards.

However, jurisdictional issues may still arise if the transaction documents include inconsistent or contradictory jurisdiction clauses.

Conflicting Jurisdiction Clauses

In addition to a derivative master agreement, entering into a transaction may involve the signing or delivery of other agreements, including credit support documents (such as guarantees) or non-credit support documents (such as credit facility documents).

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28 Foreign invested enterprises (such as Sino-foreign equity joint venture enterprises, Sino-foreign cooperative enterprises and wholly foreign owned enterprises) are considered to be Chinese legal persons. A derivative contract between a Chinese branch of a foreign bank and another Chinese party may be viewed by the Chinese courts as a domestic contract without a foreign party element notwithstanding the foreign branch is not a Chinese legal entity. However, in practice, different Chinese courts may hold different views as to the ‘foreign nature’ of such kind of entities.

29 Article 128 of the Chinese Contract Law provides that parties may agree to submit a dispute to arbitration administered by an arbitration institution.

30 For certain categories of derivative transactions between participants in China, the Chinese regulators have imposed mandatory requirements for the parties to use a prescribed form of master agreement that is governed by Chinese law, and with an exclusive jurisdiction clause for the parties to submit disputes to the Chinese courts or to Chinese arbitration. See the section in this paper headed ‘Use of Non-industry Standard Legal Documents’ for the various forms of derivative master agreements commonly used in onshore derivative transactions between Chinese parties.

25 See Article 18(2) of the NAFMII Master Agreement:

‘(ii) Dispute Resolutions
The parties may resolve, by consultation, any disputes, claims or disagreements under or in connection with this Agreement.
If the Parties do not engage in such consultation or do not reach an agreement following the consultation process, the Parties may agree to submit such disputes, disagreements or claims to China International Economic and Trade Arbitration Commission for arbitration to be conducted in Beijing in accordance with the Arbitration Rules of China International Economic and Trade Arbitration Commission then in effect; the arbitral tribunal shall consist of three arbitrators, and the arbitration award shall be final and binding on the Parties.
Where the Parties have agreed on other arbitration institutions for dispute resolution, such arbitration institution shall be an arbitration institution lawfully registered or incorporated within the territory of the People’s Republic of China (which, for the purpose of this Agreement, does not include Hong Kong Special Administrative Region, the Macao Special Administrative Region or Taiwan area), and the place of arbitration shall be located within the territory of the People’s Republic of China (which, for the purpose of this Agreement, does not include Hong Kong Special Administrative Region, the Macao Special Administrative Region or Taiwan area).
Where the Parties have agreed to resolve disputes not through arbitration but by litigation, each Party may only initiate the legal proceeding at the people’s court.’
In addressing conflicts between jurisdictional provisions in contracts, Chinese courts will generally consider the following factors:

- If there is a principal agreement and documents subsidiary to the principal agreement, the jurisdiction clause in the principal agreement will prevail.

Accordingly, if there are conflicting jurisdiction provisions between a master agreement and its credit support documents, the jurisdiction clause in the master agreement prevails.32

- If there is no principal and subsidiary relationship between the different agreements underlying the transaction, the court will assess the jurisdiction clause in each of the agreements.

With respect to a transaction involving ancillary credit facility documents33 in addition to the master agreement, there are different judicial views as to the nature of the priority relationship between the documents. There is also no consensus as to whether a facility document should be treated as a subsidiary agreement. This may give rise to the risk of a Chinese court adopting different jurisdiction clauses for particular agreements.

**Foodchem Case – Validity Of Arbitration Clauses And Different Jurisdiction Clauses In Financing Documents**

A series of cases were brought to the courts in Beijing and Shanghai during 2016 and 2017 where the plaintiff Shanghai Foodchem Co., Ltd. (Foodchem) applied for a ruling that the arbitration clause under an NAFMII agreement entered into by it with DBS (China) Co., Ltd., was invalid in respect of the dispute between Foodchem and DBS (China) Co., Ltd. Shanghai branch (DBS Shanghai Branch).

Foodchem applied to set aside the arbitration clause under the NAFMII agreement and instead rely on an ambiguous jurisdiction clause in a facility letter34 granted by DBS Shanghai Branch, which, Foodchem argued, amended the NAFMII arbitration clause.

The Chinese court rejected Foodchem’s request and held that the facility letter was executed prior to the execution of the NAFMII agreement, so it could not amend or conflict with the NAFMII arbitration clause. Therefore, the NAFMII arbitration clause was valid.

**Summary**

Onshore disputes must be submitted to the jurisdiction of a Chinese court or Chinese arbitral tribunal.

Chinese courts will consider which of the transaction documents is ‘principal’ in order to resolve inconsistencies between jurisdiction clauses in different transaction documents.

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32 Article 129 of the Security Law Interpretation provides that where there is a conflict in the choice of jurisdiction between the agreement governing the underlying debt obligations (referred to as ‘principal agreement’) and a guarantee or other types of credit enhancement agreement, the jurisdiction clause of the principal agreement prevails.

33 ‘授信文件’ in Chinese. Some facility documents are produced only for the purpose of entering into the derivative transactions, but other facility documents may cover the underlying loan transaction as well as the hedging derivatives associated therewith.

34 This document was named in Chinese as a facility letter, ‘授信函’
ENFORCEMENT OF FOREIGN JUDGMENTS

Cross-Border Disputes: Foreign Judgments Not Recognized By Chinese Courts

A judgment (including bankruptcy orders) granted by a foreign court over a Chinese entity will not be enforceable in China unless a Chinese court recognizes that judgment.

Wahaha Case – Foreign Court Orders Not Recognized In China

In the Wahaha case35 between Suqian Wahaha Hengfeng Beverage Co., Ltd (Wahaha) and KPMG Huazhen Accounting Firm (KPMG):

- Wahaha is a joint-venture established by a Chinese company (the Wahaha Group) and a company incorporated in the British Virgin Islands (Ever Maple Trading Co., Ltd.);

- Ever Maple Trading Co., Ltd was sued by Danone in the British Virgin Islands (BVI) and KPMG was appointed as the receiver of Ever Maple Trading Co., Ltd. by the BVI court;

- KPMG (in its capacity as the receiver pursuant to the offshore court orders) proceeded to receive the assets of Ever Maple Trading Co., Ltd located in China without obtaining a Chinese court’s recognition of the receivership orders against Wahaha granted outside China;

- The Chinese court held that KPMG had infringed the rights of Wahaha in exercising its receiver’s powers because the relevant receivership and asset-freezing orders granted against Wahaha by the BVI court had not been recognized by Chinese courts; and

- KPMG was held liable to Wahaha for damages arising from its infringement conduct.

The Wahaha case demonstrates that a foreign bankruptcy or similar order must be first recognized by a Chinese court before the administrator or receiver may exercise its powers against the relevant assets in China.

Cross-Border Disputes: Recognition And Enforcement Of Foreign Judgments In Chinese Courts

A Chinese court will recognize and enforce a judgment of a foreign court for a cross-border dispute pursuant to the Chinese Civil Procedures Law only if:

- Either:
  - There is an international treaty concluded or acceded to by China or other special regional arrangements for civil and commercial disputes applicable to Hong Kong, Macau and Taiwan, which provide for the recognition; or
  - There exists a ‘reciprocal relationship’ for the mutual recognition and enforcement of judgments; and
- The court determines that the judgment or ruling does not violate the basic principles of Chinese law, state sovereignty, national security, or public interest.

Recognition and enforcement of a foreign judgment in China involve two phases. First, the applicant must apply to the court for an order to recognize the judgment, which gives the foreign judgment the equivalent status of a Chinese court judgment. Second, if a recognition order is granted, the applicant may be required to file a separate case to enforce the judgment, and the case is handled by the enforcement division of the court for collection of amounts due pursuant to the judgment.

International Treaties

China is not currently a party to any conventions governing the recognition and enforcement of foreign judgments, except for the ratification of articles in the International Convention on Civil Liability for Oil Pollution Damage 1969.

China is a party to a number of bilateral treaties with foreign countries for the mutual recognition and enforcement of judgments, but there are currently no such treaties between China and important trading partners such as the UK, the US or Singapore.

Reciprocity

In the absence of an international treaty, a party may seek to enforce a foreign judgment based on the principle of ‘reciprocity’ (that is, a mutual exchange of privilege), which is a fundamental

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36 The arrangement between mainland China and Hong Kong is set out in the ‘Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region Pursuant to Choice of Court Agreements between Parties Concerned (2006)’. The arrangement between mainland China and Macau is set out in the ‘Arrangement between the Mainland and Macau Special Administrative Region on the Mutual Acknowledgment and Enforcement of Civil and Commercial Judgments (2006)’. The arrangement between mainland China and Taiwan is set out in the ‘Provisions of the Supreme People’s Court in respect of the Acknowledgment and Enforcement of the Civil Judgments Rendered by Courts in Taiwan Region (2015)’

37 Article 282 of the Chinese Civil Procedures Law

38 In this paper, the term ‘enforcement’ is used to primarily describe the first phase of the enforcement proceedings – ie, applications to recognize foreign judgments

39 For detailed examination of the recognition and enforcement of foreign judgments in China, please refer to the country report on ‘Recognition and Enforcement of Foreign Judgments in Asia’ published by Asian Business Law Institute in December 2017 (the ABLI Report)
prerequisite to recognising and enforcing a foreign judgment in commercial matters. Historically, this principle has not been widely relied upon by Chinese courts to recognize a foreign judgment, possibly because there is limited guidance or interpretation on its application. The SPC previously suggested that only ‘de facto’ reciprocity would be recognized, meaning that the courts of a foreign country must have recognized and enforced the judgment of a Chinese court in the past for the principle of reciprocity to apply. This approach by Chinese courts has led to a similar reluctance by foreign courts to recognize Chinese judgments.

As summarized below, the Liu Li case and the Kolmar case recognized and enforced two foreign judgments in China.

### Liu Li Case

Liu Li won a case against Tao Li and Tong Wu before the Los Angeles Superior Court involving a fabricated transfer of shares in a Californian company. Liu Li applied to enforce the US judgment in Wuhan where the defendants were domiciled.

After examining an earlier case where a Chinese judgment had been recognized and enforced by a US court, the Wuhan Intermediate People’s Court decided that de facto reciprocity had been established for the US judgment to be recognized and enforced. The Wuhan court also rejected the defendants’ arguments, ruling that the merits of the foreign judgment should not be considered when the Chinese court recognized and enforced the foreign judgment.

### Kolmar Case

The High Court of Singapore decided in favour of the plaintiff, Kolmar Group AG (Kolmar) in October 2015. Kolmar then applied to the Nanjing Intermediate People’s Court for recognition and enforcement of the foreign judgment against the defendant, Jiangsu Textile Industry (Group) Import & Export Co., Ltd. (Sutex).

In the absence of any bilateral or international treaty between China and Singapore as to the recognition and enforcement of their respective civil judgments, the Nanjing court held the Singaporean court had previously recognized and enforced a Chinese judgment. Therefore, based on the reciprocity principle, the Nanjing court upheld Kolmar’s claim and issued a ruling recognising and enforcing a default judgment granted by the High Court of Singapore.

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40 For example, a Japanese citizen, Gomi Akira, applied to the Dalian Intermediate People’s Court for the recognition and enforcement of a Japanese judgment. The application was subject to a request for interpretation made to the SPC by the Liaoning High People’s Court, and the SPC’s Reply on June 26, 1995 confirmed that China and Japan do not have a reciprocal relationship, and decided to reject the application for recognition and enforcement of the Japanese court judgment. In another example, the Beijing No. 2 Intermediate People’s Court held that there was no reciprocal relationship between China and the United Kingdom, and therefore rejected the application by the Russian State Symphony Orchestra and Artmont Company Limited to recognize an English High Court decision.

41 The SPC’s Reply (as defined in the section in this paper headed ‘Chinese Laws And Regulations’).

42 According to the ABLI Report, South Korean, Australian, English, Chadian, Malaysian and US judgments have been denied recognition and enforcement on the ground of lack of reciprocal relations between China and those countries. However, German, Singapore and US judgments were recognized and enforced by Chinese courts on the basis that there were established reciprocal relations, page 57-58 of the ABLI report.
The Liu Li case and the Kolmar case indicate that Chinese courts located in the same province applied the principle of reciprocity in enforcing foreign judgments granted by foreign courts that had recognized and enforced judgments decided in that same province. However, whether the reciprocity principle will be applied on a cross-provincial basis has not yet been tested.

### Summary

With some limited exceptions, Chinese courts will not recognize foreign judgments unless:

- China is party to an international treaty for recognition of foreign judgments;
- The judgment is awarded by a court in Hong Kong, Macau or Taiwan and the request for recognition and enforcement is made pursuant to mutual arrangements between mainland China and Hong Kong, Macau or the SPC’s judicial interpretation regarding Taiwan judgments; or
- The judgment is awarded by a court in a jurisdiction that enjoys de facto reciprocity with China.

### Other Grounds For Not Recognising Foreign Judgments

Other than the absence of international treaties, special arrangements or de facto reciprocity principles, the other most frequently used grounds for not recognising or enforcing a foreign judgment are:

- The foreign judgment was not valid, conclusive or enforceable;
- There was a lack of jurisdiction of the foreign court over the dispute, or the parties are subject to the exclusive jurisdiction of Chinese courts; and/or
- There were procedural flaws during the court proceedings, such as the improper service of process.

Generally speaking, invoking ‘public policy’ as the ground for not recognising an otherwise properly awarded foreign court judgment is relatively rare in Chinese court proceedings.

### Developments In Recognising And Enforcing Foreign Bankruptcy Judgments

There have been important developments in bankruptcy cases. Chinese courts are now more willing to recognize foreign bankruptcy cases when courts in other foreign jurisdictions recognize and enforce Chinese bankruptcy judgments. For example, the High Court of Hong Kong recognized and enforced the mainland bankruptcy judgment over Guangdong International Trust and Investment Corporation (GITIC) in November 2001. This was followed by the Foshan Intermediate People’s Court recognising an Italian bankruptcy judgment on B&T Ceramic Group s.r.l pursuant to the Chinese Civil Procedures Law and the Sino-Italy Civil Judicial Assistance Treaty.

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43 For example, in the Kolmar case, the court of Nanjing (located in the capital city of Jiangsu Province of China) applied a reciprocity principle on the rationale that a Singaporean court had enforced a Chinese judgment ordered by a court of the Jiangsu province. In the Liu Li case, the court of Wuhan (located in a capital city of Hubei Province) applied a reciprocity principle on the rationale that the US court had enforced a judgment made by the Chinese court in Hubei.

44 See page 69 of the ABLI Report.
With the promulgation of the Chinese Bankruptcy Law in 2007, rules were introduced for the recognition of foreign bankruptcy judgments in China, which largely follow the principles applicable to the recognition and enforcement under the Chinese Civil Procedures Law, with certain variations. Under Article 5 of the Chinese Bankruptcy Law:

‘where a foreign court's judgment or ruling on a bankruptcy case that has taken effect involves assets in the territories of the People's Republic of China held by a debtor, and an application or request for judicial recognition and enforcement of the judgment is made to the People's Court, the People's Court shall, pursuant to the international treaty that the People's Republic of China has concluded or is a member of, or pursuant to the principle of reciprocity, examine the application or request; where the People's Court deems that the application or request will not violate the basic principles of law of the People's Republic of China, threaten national sovereignty, security and public interest, and will not impair the lawful rights and interests of the creditors within the territory of the People's Republic of China, the People's Court shall make a ruling on recognition and enforcement’

(own emphasis)

The condition ‘not to impair the lawful rights and interests of the creditors in China’ under the Chinese Bankruptcy Law is an additional pre-requisite to the recognition of a foreign bankruptcy judgment. That condition, the eligibility requirement of the applicant, as well as what constitutes a foreign competent court with jurisdiction, are yet to be clarified by further Chinese judicial guidance.

Foreign bankruptcy cases involving non-monetary foreign judgments have been recognized and enforced by certain local Chinese courts.

**Other Recent Developments Relating To The Enforcement Of Foreign Judgments In China**

**Belt And Road Initiatives**

The Belt and Road Opinion sets out a number of high-level principles and general opinions that encourage Chinese courts to facilitate the implementation of the Belt and Road initiative by providing appropriate judicial services and safeguards, including ensuring the protection of the legitimate rights and interests of both Chinese and foreign parties, respecting jurisdiction and the parties’ right to agree dispute resolution mechanisms.

For example, in dealing with Belt and Road countries that have not concluded bilateral or multilateral agreements with China for the mutual recognition and enforcement of judgments, Chinese courts are encouraged to provide judicial assistance to promote a relationship of reciprocity with such country.

Although these high-level principles and general opinions are not binding, they signal a willingness to reform the Chinese judicial system to facilitate international commerce.

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45 According to the ABLI report, a French bankruptcy judgment and a German bankruptcy judgment were respectively recognized by local Chinese courts: (2005) SUI ZHONG FA MIN CHU ZI No 145 ((2005) 穆中法民三初字第146号民事裁定); (2012) E WUHAN ZHONG MIN SHANG WAI CHU ZI No 00016 ((2012)鄂武汉中民商外初字第00016号), at page 64, ABLI Report

46 Article 6 of the Belt and Road Opinion
Hague Convention

China became a member state of the Hague Convention on September 12, 2017.47

Whilst China has not yet ratified the Hague Convention, the fact that China is now a member state signals the Chinese government’s respect for contracting parties’ autonomy to select their choice of forum in international commercial agreements.

In the meantime, enforcement of foreign judgments in the Chinese courts will generally be based on the principles examined above.48

Nanning Declaration At The 2nd China-ASEAN Justice Forum

A joint declaration was approved at the 2nd China-ASEAN Justice Forum held on June 8, 2017 in Nanning, China.

Under the Nanning Declaration, ‘reciprocity is assumed to exist if there is no case of refusal of enforcement in the originating state because of the lack of reciprocity.’ The declaration signals the establishment of the ‘deemed reciprocity’ principle between China and member states of the Association of Southeast Asian Nations (ASEAN).

Drafting Interpretation On Recognition And Enforcement Of Foreign Judgments

Representatives of the SPC have stated publicly that the SPC encourages the application of the reciprocity in the recognition and enforcement of foreign civil and commercial judgments in China. It has been reported in China that the SPC is formulating a judicial interpretation on certain issues concerning the recognition and enforcement of foreign civil and commercial judgments.

48 For further information about the enforcement of foreign judgment in China and China’s signing of the Hague Convention, please refer to articles published by King & Wood Mallesons entitled (1) ‘Enforcing your judgment in China: The truth’ by James Guan and Meg Utterback and (2) ‘The Choice of Court Agreement and Its Implications on China’ by James Guan
ENFORCEMENT OF ARBITRAL AWARDS

Enforcement Of Foreign Arbitral Awards

The risk of a Chinese court refusing to enforce an award granted by an international arbitration institution in China is low.

Similar to the recognition and enforcement of a foreign judgment, recognition and enforcement of a foreign arbitral award in China involves two phases. First, the applicant must apply to the court for an order to recognize and enforce the international award, which gives the award the equivalent status of a court judgment. Second, the applicant may be required to file a case to enforce the award, and if an order for recognition and enforcement is issued, the case is transferred to the enforcement division of the court for collection of amounts due pursuant to the award.

A Chinese court may only decline to enforce an award granted by a foreign arbitration institution for cross-border disputes on certain grounds, including:

- The award is contrary to public interest;
- The relevant notices have not been delivered to the respondent or the respondent has not been given a chance to respond;
- There is no valid arbitration agreement between the parties;
- The constitution of the arbitral tribunal or the arbitral proceedings contravenes the relevant arbitration rules; or
- The dispute relates to matters that are outside the scope of the arbitration agreement or the jurisdiction of the relevant arbitral tribunal.

The Arbitration Reporting Provisions provide that if any intermediate court or special court proposes to:

- Invalidate an arbitration clause;
- Not enforce or revoke an arbitral award rendered by a Chinese arbitration institution;
- Not recognize or enforce an arbitral award rendered in Hong Kong, Macau, or Taiwan; or
- Not recognize or enforce a foreign arbitral award,

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50 This paragraph does not consider arbitral awards made in Hong Kong, Macau or Taiwan. The recognition and enforcement of such awards is made in accordance with the relevant mutual arrangements between mainland China and Hong Kong, Macau, or the relevant judicial interpretation of the SPC regarding the arbitral awards in Taiwan.

51 Publicly available information concerning the second phase is limited and is thus beyond the scope of this paper. By ‘enforcement’, only the first phase of the proceedings is addressed – ie, applications to recognize and enforce foreign arbitral awards.

52 Article 283 of the Chinese Civil Procedures Law and Article V of the New York Convention (which has a substantially same content with Article 274 of the Chinese Civil Procedures Law).

53 Pursuant to Article 283 of the Chinese Civil Procedures Law and the Notice of the Supreme People’s Court on Implementing the Convention on the Recognition and Enforcement of Foreign Arbitral Awards Acceded to by China.

54 In general, a Chinese court is unlikely to rely on ‘public interest’ to decline to enforce a properly obtained arbitral award.
that court must file an application for verification with the high court. Where the high court decides to approve the application, it must file an application for verification with the SPC.\textsuperscript{55} This practice (also known as the SPC reporting system) is designed to ensure awards are enforced, especially if the entity subject to the award is an SOE established in the region where the court that proposes to reject the application is located.

The SPC held in the China Sugar case that only egregious violations of public policy and national Chinese law justify a court not enforcing a properly obtained foreign arbitral award, and acknowledged that a violation of a mandatory Chinese law was not necessarily a violation of public policy of China. Chinese courts are required to adhere strictly to international convention principles in exercising their jurisdiction over an arbitration conducted under the New York Convention. In practice, most Chinese courts will not interfere with an arbitral award obtained through a properly constituted and commenced arbitration conducted in accordance with the arbitration rules of a reputable arbitration body (such as a well-recognized foreign arbitration centre)\textsuperscript{56}.

**China Sugar Case – Recognition And Enforcement Of An International Arbitral Award**

China National Sugar Alcohol Group Corp. (China Sugar) entered into a futures contract with E.D. & F Man (Hong Kong) Limited (ED&F). China Sugar failed to provide letters of credit as required under a contract between the parties and ED&F submitted the dispute to the London Sugar Commission for arbitration.

The London Sugar Commission granted the award in favour of ED&F, and ED&F requested the Beijing No. 1 Intermediate People’s Court to recognize and enforce the arbitral award. The Beijing High People’s Court proposed to decide that China Sugar had the capacity to enter into the transactions but found that the futures contracts were entered into by China Sugar for speculative purposes, which violated Chinese law and hence jeopardized the public policy of China.

In the response to the Beijing court’s inquiry, the SPC however ruled that breach of the mandatory provisions under Chinese law did not necessarily put the public policy of China in jeopardy. Recognition and enforcement of the London Sugar Commission’s award were allowed.

Although it is generally difficult to set aside a foreign arbitral award in China, there remains a risk that the procedural requirement for a court to recognize and enforce an arbitral award gives the respondent an opportunity to challenge the award, causing delay and additional costs.

\textsuperscript{55} The Foreign Arbitration Circular issued in 1995 also provides that, if an intermediate people’s court intends to reject an application to enforce a foreign arbitral award or a foreign-related award of a Chinese arbitration commission, it must refer the application to a higher court for review before making the decision. The higher court must refer the application to the SPC in Beijing.

\textsuperscript{56} This is based on King & Wood Mallesons’ experience in representing international clients in their onshore arbitration proceedings involving derivative contracts. Please refer to the article by King & Wood Mallesons entitled ‘Enforcing foreign arbitral awards in China – a review of the past twenty years’ written by Meg Utterback.
The Arbitration Review Provisions that came into effect on January 1, 2018 established a detailed procedure for a defendant to challenge the jurisdiction of a Chinese court to hear certain types of arbitration review cases (including disputes arising from applications for recognition and enforcement of foreign arbitral awards)\(^{57}\). Any challenge to the Chinese courts’ jurisdiction will be conducted before hearing the merits of a case. The losing party is entitled to appeal to a higher court. Therefore, a respondent’s procedural right to challenge jurisdiction is likely to cause delay in the arbitral award enforcement proceedings.

**Summary**

The grounds for a Chinese court to deny the recognition and enforcement of an award granted by a foreign arbitral tribunal are very limited and a court’s refusal to grant recognition is subject to the ‘SPC reporting system’.

**Enforcement Of Domestic Arbitral Awards**

A Chinese court may only revoke or reject the enforcement of a domestic arbitral award involving foreign elements on limited grounds of procedural non-compliance\(^{58}\). The analysis above applies to the enforcement of domestic arbitration awards involving foreign elements (such as where one party is a foreign person). The SPC reporting system described above also applies to enforcement of domestic arbitral awards involving foreign elements.

In the case of a domestic arbitral award for an onshore dispute not involving a foreign element, a Chinese court may reject the enforcement of the award on broader, and more substantive, grounds pursuant to Article 237 of the Chinese Civil Procedures Law.

In addition to the reasons listed in the Enforcement of Foreign Arbitral Awards section of this paper, the grounds under Article 237 of the Chinese Civil Procedures Law include:

- Whether the evidence on which the award was based is forged;
- Whether the evidence that is key to the granting of a fair award is concealed by a party; and
- Whether the award was improperly or unfairly obtained (for example, where an award was obtained as a result of forgery, withholding of evidence, bribery or corruption).

In the Foodchem case, the plaintiff made some of these arguments to set aside the arbitral award granted by CIETAC Shanghai sub-commission but all were rejected by the court.

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\(^{57}\) Other than applications for recognition and enforcement of foreign arbitral awards, the Arbitration Review Provisions also apply to the following cases: an application to confirm the effectiveness of an arbitration agreement; an application for enforcement of an arbitral award made by a Chinese arbitration institution; an application to cancel an arbitral award made by a Chinese arbitration institution; an application for recognition and enforcement of an arbitral award made in Hong Kong, Macau or Taiwan; and other judicial reviews of arbitration. This is not repeated in discussions below concerning the enforcement of domestic arbitral awards

\(^{58}\) Article 274 of the Chinese Civil Procedures Law
Foodchem Case – Setting Aside A Domestic Arbitral Award

Foodchem filed a request to the Beijing No. 2 Intermediate People’s Court to set aside the domestic arbitral award issued by CIETAC in May 2017.

In response to the allegations raised by Foodchem, the Beijing court examined:
- The existence and validity of the NAFMII arbitration provisions;
- The constitution of the arbitral tribunal;
- The allegation as to the concealed evidence;
- The allegation as to granting the award by perverting the law; and
- The public interest test.

The court did not accept any of these allegations because Foodchem failed to submit any supporting evidence. The Beijing court rejected the claim by Foodchem, and upheld the CIETAC arbitral award.

The court in the Sunshine Paper case accepted the arguments of the defendant company and refused to enforce an award granted by CIETAC Shanghai sub-commission59.

Sunshine Paper Case

Shandong Century Sunshine Paper Group Co., Ltd. (Sunshine Paper) entered into an NAFMII Agreement with Deutsche Bank (China) Limited Shanghai branch (DB China). The parties entered into a US dollar-denominated structured swap linked to US dollar LIBOR and euro EURIBOR. Sunshine Paper failed to make a payment so DB China terminated the transaction early. The dispute was submitted to CIETAC Shanghai sub-commission and an award was granted in favour of DB China.

DB China requested the Shandong Weifang Intermediate People’s Court to enforce the arbitral award but the request was rejected.

Sunshine Paper argued that DB China concealed evidence that was key for CIETAC Shanghai sub-commission to grant a fair arbitral award. The court noted that DB China’s parent Deutsche Bank AG was reportedly involved in the manipulation of LIBOR and EURIBOR. Such information was not disclosed by DB China to the arbitration institution when the case was originally heard, and if it had been disclosed to CIETAC Shanghai sub-commission, the arbitration institution should have taken a more prudent and careful assessment of the dispute.

DB China appealed to the Shandong High People’s Court and the trial judgment was repealed60. The Weifang Intermediate People’s Court was ordered to re-hear the case. Eventually, however, the judgment was similar in substance to the original judgment and DB China’s request to enforce the arbitral award was rejected again.

59 As highlighted in the case note for Sunshine Paper case below, the procedural right (if any) to appeal or review (复议或异议) is no longer allowed pursuant to the Civil Procedures Law Interpretation

60 Although DB China succeeded in submitting the review to the Shandong High People’s Court, it was not clear at that time whether DB China was entitled to appeal the trial court’s rejection of enforcement of a domestic arbitral award
Similarly, in the enforcement process of the 2016 CIETAC Shanghai arbitration decision\(^61\), a local court relied on a submission by the defaulting party alleging that the applicant bank had concealed evidence about the unwinding of its hedge position and the actual loss during the arbitration that affected the making of an impartial award by the arbitral tribunal and denied the enforcement of the arbitral awards.

Recent judicial interpretation issued by the SPC clarifies the circumstances in which an arbitral award will not be enforced under Article 237 of the Chinese Civil Procedures Law. Two key clarifications are:

- Article 16 of the Arbitration Enforcement Provisions elaborates on what constitutes a party having concealed evidence that denies a fair judgment under Article 237(2)(v) of the Chinese Civil Procedures Law - if\(^62\):
  - The evidence is important in identifying the basic facts of the case;
  - The evidence is only available to the other party but was not submitted to the arbitration tribunal; or
  - The existence of the evidence was discovered during the arbitration proceedings, and the other party was required to produce it, or the arbitration tribunal had requested or ordered the other party to produce it, but the other party failed to produce it without justification,

  the Chinese court will not support the application for enforcement of the arbitral award because the evidence concealed affected the making of an impartial award; and

- Article 18 of the Arbitration Review Provisions clarifies that an arbitrator soliciting or accepting bribes, favouritism or delivering an award under Article 237(2)(vi) of the Chinese Civil Procedures Law must be decided by a criminal judgment or other disciplinary decision\(^63\).

The Arbitration Reporting Provisions, for the first time, subject domestic arbitration cases (involving no foreign element) to the same ‘SPC reporting system’ as applies to foreign arbitral awards – see the section in this paper headed Enforcement of Foreign Arbitral Awards, but with certain additional conditions\(^64\).

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\(^61\) A chemical company claimed that the benefits it gained under transaction linked to crude oil prices were disproportionate to its risk exposure. The CIETAC Shanghai sub-commission issued an arbitral award in 2016 in favour of the bank, but the chemical company filed a petition to the local court to set aside the arbitral award


\(^64\) Article 3 of the Arbitration Reporting Provisions provides that, if a high court, upon review of the case reported by the lower court, decides to approve the determination of the lower court that an arbitral agreement is invalid, the high court must file an application for verification with the SPC under any of the following circumstances: the parties are in different provincial administrative regions (‘cross-provincial’); or the arbitral award is not enforced or is revoked on the ground of violating public interest
Summary

Chinese courts will assess domestic arbitral awards involving foreign elements (such as where one party is a foreigner) in the same way as foreign arbitral awards.

If a court refuses the recognition and/or enforcement of a foreign or foreign-related arbitral award, it is required to follow the SPC reporting system and report to the SPC.

Chinese courts will assess domestic arbitral awards (not involving foreign elements) against the broader criteria set out in Article 237 of the Chinese Civil Procedures Law including factors such as:

- Whether evidence was forged;
- Whether a party concealed evidence; and
- Whether the award has improperly or unfairly obtained.

If a Chinese court does not enforce a domestic arbitral award (not involving foreign elements) that is cross-provincial or violates the public interest, the court is required to follow the SPC reporting system and report its rejection to the SPC as well.
CONTRACT FORMATION, VALIDITY AND ENFORCEABILITY

OVERVIEW

General Rule On Validity Of Contracts Under Chinese Contract Law

A Chinese court will generally enforce a contract pursuant to the Chinese Contract Law unless:

- The contract is invalid under Article 52 of the Chinese Contract Law because:
  - It is concluded through the use of fraud or coercion by any party resulting in damage to the interests of China;
  - It involves malicious collusion between the parties that harms the interests of China or other entities or third parties;
  - The purpose of the contract is illegal and the illegal purpose is disguised through legal forms or activities;
  - It causes damage to the public interest; or
  - It violates the mandatory provisions of law or administrative regulations - this means mandatory provisions determining the validity of a contract under:
    - Laws published by the National People's Congress and its Standing Committee, and
    - Regulations published by the State Council; or

- The contract may be amended or rescinded pursuant to the petition of a party under Article 54 of the Chinese Contract Law on any of the following grounds:
  - The contract was concluded due to a gross misconception;
  - The contract was grossly unconscionable at the time of its conclusion; or
  - The contract was concluded against the true intention of a party by means of fraud or duress, or by taking advantage of the other party's hardship.

Where a party petitions for amendment of the contract, the court or arbitration tribunal may not, in its discretion, decide to terminate the contract.

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65 This is explained under Article 4 of the Contract Law Interpretation (I) and in ‘The Explanatory Notes on the Chinese Contract Law’ written by the Legislative Affairs Commission of the Standing Committee of the National People’s Congress. The Contract Law Interpretation (II) further provides that the term ‘mandatory provisions’ referred to in Article 52 of the Chinese Contract Law should be confined to ‘mandatory provisions on validity’ only (in other words, a violation of mandatory provisions relating to administrative or management related issues may not invalidate a contract)
Validity Of Transactions And Derivative Contracts – Common Allegations

The most common grounds used by a counterparty to challenge the validity of a derivative transaction are:

- An allegation that the contract has not been concluded, which may involve consideration of whether all transactions under a derivative contract constitute a ‘single agreement’;

- An allegation that the individual representative of a corporate counterparty who executed the transaction lacks the authorisation to act on behalf of the company;

- Will typically confirm with its counterparty by telephone the missing parameters and reiterate the key terms settled previously during negotiation; and
  
  - Identifying the documents that constitute the transaction documents;
  
  - Implications of bespoke terms deviating materially from standard derivative industry documents;

- An allegation that a transaction constitutes gambling due to its speculative nature (on the basis of damage to the public interest), or has unfair product terms (ie, unconscionability);

- An allegation that a party to the transaction lacks capacity in violation of the mandatory provisions of law or administrative regulations in China;

- A recharacterisation of the derivative contract as a wealth management product or an agency agreement, which will generally impose more stringent legal or regulatory obligations on the bank;

- For a derivative contract governed by Chinese law, an allegation that an early termination amount is invalid or subject to adjustment on the ground that:
  
  - It exceeds the amount of actual damages permitted under the Chinese Contract Law’s principles for ‘liquidated damages’;
  
  - There was a lack of performance by the parties under the derivative contract; or
  
  - There was an unfair determination of the early termination amount or other valuation under the mechanism prescribed in the contract; or

- Allegations by the counterparty of fraud or misconduct during the contract formation process (see the Mis-selling Claims And Pre-trade Requirements section of this paper for a summary of how mis-selling might affect the validity of a derivative contract).
CONCLUDED DERIVATIVE CONTRACTS

When Is A Transaction Concluded? What Is The Implication Of The ‘Single Agreement’ Concept On The Formation Of A Derivative Contract?

A Chinese court will typically assess whether there is a concluded contract (involving the examination of the existence of offer and acceptance and when the contract was formed).

Chinese courts will assess the contracting parties’ intention to be bound by a contract and the subject matter of the contract. Article 12 of the Chinese Contract Law lists terms that should generally be included in a contract, including the subject matter, quantity, consideration or price, tenor, performance location and method. Although that list is only indicative, and the absence of one or more of the terms does not necessarily render the contract invalid, it is not uncommon for a Chinese court to treat the certainty of the ‘subject matter’ as necessary to constitute offer and acceptance and a binding contract.

A master derivative contract only sets out the mechanism for entering into transactions, without any detailed terms of any particular transaction. The underlying transactions will normally not be ascertained upon signing of the master derivative contract. A Chinese counterparty may argue that, notwithstanding the signing of the master derivative contract, there is no effective agreement for a specific transaction until all the key transaction terms (as set out in Article 12 of the Chinese Contract Law) are confirmed between the parties.

A recurring issue is whether multiple transactions under a master derivative contract should be treated as a single agreement, or multiple derivative contracts formed on the signing of the confirmation for each transaction.

The two possible views are:

- Where the single agreement concept is recognized, a derivative contract is formed upon signing the master derivative contract, and each underlying transaction constitutes the performance of outstanding obligations as contemplated under the master derivative contract on each individual trade date. Each confirmation of a transaction does not represent a separate agreement of the parties; and

- Where the single agreement concept is not recognized, a derivative contract is formed in respect of each transaction notwithstanding all transactions have been entered into under the same master derivative contract.

A counterparty may allege that multiple transactions under the same master derivative contract constitute separate contracts, which should be subject to separate disputes and proceedings.

Summary

Whether the single agreement concept is recognized under Chinese law has an impact on when the derivative contract is concluded and how many derivative contracts are disputed.

If the single agreement concept is not recognized and the derivative contract is concluded each time when a transaction is confirmed, then the bank may face separate and independent disputes and proceedings.
How Is A Transaction Concluded?

A Chinese bank that intends to enter into a transaction with a counterparty under a master derivative contract:

- Will normally provide a term sheet to the counterparty (or require the counterparty to complete certain information in a transaction order application form);

- Will communicate with its counterparty through emails, telephone and/or other communication to settle the transaction terms (other than the specific parameters such as pricing to be confirmed upon the conclusion of the transaction) in the term sheet;

- Will typically confirm with its counterparty by telephone the missing parameters and reiterating the key terms settled previously during negotiation; and

- After a transaction has been concluded by phone, will provide a trade confirmation documenting the final terms. Master derivative contracts commonly provide that any delay or failure in sending the confirmation should not affect the validity of the relevant derivative contract. A trade confirmation serves merely as an evidence of the contract terms agreed verbally by phone.

In the absence of a well-established practice for the enforcement of derivative contracts across China, there remains a risk that individual local courts may request production of a written contract agreed and signed by both parties prior to the verbal confirmation of the final trading terms by phone. To the extent that any written transaction document is incomplete or has any error or omission or the relevant transaction confirmation is not signed by both parties, the counterparty may argue there is no contract and that the transaction was never concluded.

Zhongmei Case – Derivative Contracts Not Concluded?

Standard Chartered Bank (China) (SCB China) claimed against Zhongmei Technology (Shanghai) Co., Ltd. (Zhongmei), for its failure to perform its payment and delivery obligations under a master derivative contract.

The mini-master documents included the Terms and Conditions for Foreign Exchange Business and an indicative term sheet. The Terms and Conditions for Foreign Exchange Business constituted the bespoke master derivative contract, and the term sheet indicated the parties’ agreement on the trade terms, which comprised a ‘risk warning’ and a ‘pre-trade confirmation’. These documents were signed by authorized persons on behalf of Zhongmei.

Zhongmei negotiated the transaction with SCB China through the staff of its parent company’s financial department. Zhongmei’s parent company’s staff confirmed the trade terms and issued certain instructions by phone calls on the day on which the term sheet for the relevant transaction was signed. Zhongmei, however, did not sign any trade confirmation, and refused to perform its payment obligations on the scheduled settlement date. SCB China then terminated the transaction and claimed its loss.

It is assumed that the signatories representing a party are authorized to sign the master derivative contract and the traders are authorized to sign other transaction documents and confirm the trade terms through phone calls or emails, and the bank has obtained the counterparty’s complete authorisation documents.
The case was submitted to the trial court and then to the Shanghai No. 1 Intermediate People's Court. The court decided the derivative transaction was not concluded because:

- The bespoke master derivative contract deviated substantially from the ISDA/NAFMII Master Agreement. It had no confirmation with detailed terms such as underlying assets and prices, and could not satisfy the ‘single agreement’ requirement. It could not be established that the parties had reached any agreement on the trade terms;

- Although the term sheet (including the pre-trade confirmation) had been signed by the authorized persons of Zhongmei, it clearly stated that ‘it is for discussion only and does not constitute any offer’. As such, the term sheet did not form part of the derivative contract that bound Zhongmei; and

- The staff of Zhongmei’s parent company who confirmed the trade terms with SCB China had no authority to represent Zhongmei. No ‘apparent authority’ could be established merely on the identity and undertakings of the staff of Zhongmei’s parent company. Accordingly, the acts and instructions of the staff of Zhongmei’s parent company did not bind Zhongmei.

The court held that whilst SCB China negligently entered into the derivative transaction without obtaining due authorisation of its counterparty, SCB China’s counterparty, Zhongmei, had not acted in good faith during the transaction. Each party should therefore bear corresponding responsibilities, in this case, on a 50%-to-50% basis.

Upon retrial, the Shanghai High People’s Court affirmed the lower Shanghai court’s decision.

The Zhongmei case reflects a risk that a Chinese court that is not familiar with OTC derivative transactions may find that a derivative contract is formed when the trade confirmation is signed by both parties rather than when the parties agree orally to the terms.

**Summary**

It is very important to ensure that the terms of each transaction are documented, and trade confirmations are promptly signed by the parties.

A counterparty’s representatives (whether as signatory or a negotiator of the trade terms) must be authorized.
GAMBLING AND UNFAIR PRODUCT TERMS

Gambling

The Chinese Contract Law provides that any contract that harms the public interest of the society is invalid. Gambling is generally viewed against public order, and likely to cause harm to individuals and indirect harm to the public interest. Gambling is therefore illegal under Chinese law. Defaulting counterparties often seek to invalidate transactions by alleging the purpose of a transaction was to speculate on the value of the underlying asset and therefore tantamount to gambling, and invalid.

Derivative contracts provide risk management tools rather than promote gambling and their legality is expressly recognized in judicial practice. There is also an express regulatory basis for the use of derivative transactions by banks under the Derivative Transactions Interim Measures.

Chinese judges and arbitrators have repeatedly rejected arguments that derivative transactions constitute gambling.

Unfair Terms Of A Derivative Product

An allegation that a derivative product is gambling or speculative in nature is often accompanied by an argument that the product terms constitute an ‘unfair design’, and is therefore invalid and/or revocable.

To argue a derivative contract as an unfair design, a defaulting counterparty tends to allege that:

- There is an unconscionable contract; or
- The terms of standard form contract prescribed by a bank are designed to transfer the bank’s risks and liabilities to its counterparty, exposing its counterparty to unlimited losses, particularly where:
  - The counterparty’s potential gains are capped, or
  - The bank’s potential losses are limited.

In practice, a Chinese court or arbitral tribunal will often:

- Assess the bargaining power of the parties (these types of cases normally involve a Chinese bank or financial institution);
- Determine if there had been fair negotiations including whether the defaulting party had a general understanding of the relevant market and its risk exposure; and
- Be generally of the view that a structure with a capped return against unlimited potential loss does not render it an unfair term per se, in particular where the defaulting party enjoyed a specific benefit (such as a discounted price to acquire an underlying asset exposure or reduction of its hedging costs).

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67 For example, the disputes arising from or in connection with derivatives are categorized as ‘disputes over trading of financial derivatives’ in Chinese civil procedures (see the Naming Code of the Civil Cases since 2008).

68 For example, in the 2016 CIETAC Shanghai arbitration decision, the arbitral tribunal upheld the validity of certain derivative contracts and rejected the defaulting party’s allegation that the derivative contracts constituted gambling. The arbitral tribunal referred to Article 2 of the Chinese Securities Law, the Futures Trading Regulation, the OTCD Product Definitions and the Derivative Transactions Interim Measures.

69 ‘格式合同’ in Chinese.
Parties should carefully document the negotiation process of any transaction to ensure there are clear records of the key terms disclosed or discussed during the negotiation.

Recent arbitral tribunal and court decisions in which a party sought to challenge the fairness of the terms of a transaction are summarized below.

**CIETAC Arbitration Decisions**

In the 2016 CIETAC Shanghai arbitration decision, a chemical company claimed that the benefits it gained under the transaction linked to crude oil prices were disproportionate to its risk exposure.

The tribunal rejected the argument and held the claim by the company that the provisions ‘aggravated its liability’ was the highest risk that the chemical company may potentially bear in the worst market conditions and was not an ‘aggravation of liability’ per se. The tribunal pointed out the key pricing terms and provisions were agreed between the parties and reflected the company’s own expectations of the market. Although the revenue/gains of the company were limited, it had obtained a discount on the exercise price, and hence there was no exclusion of its rights. The tribunal held that although the trade terms were agreed in a contract in fixed form, they were not invalid.

In the 2017 CIETAC Beijing arbitration decision, an import and export company challenged the fairness of the transaction. The arbitral tribunal decided the evidence was the company made various requests to the bank during the negotiation of the key terms. Therefore, the trade terms signed by the company reflected both parties’ agreement based on their reasonable expectations and own trading needs. The company also confirmed in the relevant transaction application documents that the transaction met its hedging needs. Therefore, the tribunal held that the transaction was not intended to aggravate one party’s liability and/or exclude one party’s rights.

**Li Shoujia Case**

In Li Shoujia v Bank of China, Beijing Shangdi Xinxi Road Sub-branch (BOC Beijing), Mr Li brought a claim against BOC Beijing, requesting BOC Beijing to compensate Mr Li for the loss (premium) he suffered in relation to certain gold option transactions. According to Mr Li, BOC Beijing’s gold options business was a disguised form of fraud and that the transactions between them should be invalid. BOC Beijing was alleged to have failed to conduct a risk assessment on Mr Li, as well as disclose the transaction risks to Mr Li or obtain the requisite representations or confirmation from Mr Li before entering into the transaction. Accordingly, Mr Li alleged that the transaction was conducted with no transparency or fairness, and his interests were harmed.

The Beijing No. 1 Intermediate People’s Court rejected Mr Li’s argument and held that Mr Li being an individual with full civil conduct capacity should have a clear understanding of the risks associated with the gold options business. In addition, other than the two gold option transactions in dispute, Mr Li had previously benefited from another gold option contract, which clearly indicated Mr Li’s experience in trading gold options. Finally, the court had reasons to doubt whether Mr Li’s claim in his case was made in good faith.
When seeking to invalidate a derivative contract transacted with a bank on the ground of ‘unfair design’, a defaulting party will usually accuse the bank of mis-selling, including by way of fraud or duress. If a Chinese court accepts these allegations, the affected contract is revocable pursuant to Article 54 of the Chinese Contract Law. That said, mis-selling claims will usually be considered by Chinese courts as a regulatory issue rather than invalidating the contract or rendering the contract revocable. Please refer to the section in this paper headed **Mis-selling Claims And Pre-trade Requirements** for details.

**Summary**

Derivative transactions with genuine business needs are unlikely to be struck down by arguments that they:

- Constitute gambling; or

- Contain unfair terms provided that the counterparty understands its risk in entering into the transaction and onerous terms are able to be weighed against benefits to the counterparty.

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70 This is based on King & Wood Mallesons’ experience in handling cases where similar arguments were raised by defaulting counterparties.
CAPACITY, QUALIFICATION AND AUTHORISATION

A counterparty often seeks to challenge a transaction on the ground that it or its counterparty does not have the requisite capacity to enter into a derivative contract.

For example, where a counterparty’s articles of association do not provide for it to undertake derivative transactions (most articles of association would not contemplate entering into derivative transactions), the counterparty may allege that it lacks a genuine business reason to enter into the transaction in an attempt to:

- Reduce the quantum of damages based on a breach of Chinese licensing regulations or required approval requirements; or
- Render the transaction null and void if it constitutes a breach of the mandatory provisions of Chinese law or administrative regulations pursuant to Article 52 of the Chinese Contract Law (see the section in this paper headed General Rule on Validity of Contracts under Chinese Contract Law).

This paragraph examines the capacity, qualification and authorisation issues frequently raised in disputes over derivative transactions under Chinese law.

Concepts Of ‘Civil Capacity’ Under Chinese Law

The capacity of a person generally refers to the legal ability of an individual or an entity (such as a company) to enter into a legally binding contract.

Under English law, whether a person has capacity to enter into a particular transaction depends on its legal status rather than the type of business it is engaged in. Regulated institutions may be subject to limitations on the types of activity in which they may engage, however those regulatory requirements are separate to the question of capacity71.

Under Chinese law, in assessing whether a person has the capacity to enter into a transaction, the key considerations relate to whether the person possesses:

- The necessary ‘civil right capacity’ (which means the capacity to enjoy civil rights and bear civil liabilities under Chinese law); and
- The necessary ‘civil conduct capacity’ (which means the capacity to conduct civil acts and assume the legal consequences under Chinese law).

There are critical differences in the legal concepts of ‘civil right capacity’ and ‘civil conduct capacity’72 for a natural person, but not in the context of a legal person (such as a Chinese company).

For example, a minor below the age of 18 possesses civil right capacity but may not have the civil conduct capacity to enter into a binding contract, whereas an adult possesses both of the civil right capacity and civil conduct capacity under Chinese law.

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71 Simon Firth, Derivatives Law and Practise, R.30: October 2015, Part 2, Chapter 2, Sub-section (a), Para 2.003

72 The Chinese phrase is ‘民事行为能力和权利能力’
In respect of a legal person, its civil right capacity and civil conduct capacity are not clearly distinguished under Chinese law, and this paper refers to them collectively as ‘civil capacity’. The general principle under Chinese law is that a legal person’s ‘civil capacity’ should be assessed by reference to the following factors:

- The nature of the legal person;
- The approved business scope of the legal person, express or implied, as set out in its articles of association and registered as set out in its business licence; and
- Whether the legal person has obtained and maintained all administrative supervision licences and approvals necessary for carrying out a particular business or transaction.

This paper does not distinguish between civil right capacity and civil conduct capacity for a Chinese legal person.

The ‘civil capacity’ of a Chinese counterparty is often considered in the context of issues relating to a person’s business scope permitted under its articles of association and business licence, as well as the applicable administrative licence and/or approvals.

**Capacity And Qualification Of A Counterparty To Enter Into A Transaction**

Under Chinese law:

- An enterprise legal person is required to conduct its business within the approved business scope for which it is registered;
- Article 11 of the Chinese Company Law stipulates that a company shall engage in business activities within its registered business scope, and a company’s business scope shall be set out in its articles of association, and registered in accordance with law; and
- Any business activities restricted by laws and administrative regulations should only be carried on after the necessary approvals have been obtained in accordance with applicable Chinese law.

These regulations generally require companies to enter into contracts that are within their business scope as stated in their articles of association.

However, the Contract Law Interpretation (I) clarifies that a contract entered into by a legal person exceeding its approved business scope will not necessarily be void or invalid provided that it does not constitute business of a type restricted, prohibited or otherwise subject to a special licensing requirement under Chinese law. Therefore, the lack of ‘civil right capacity’ is rarely used as the sole ground to invalidate a contract in Chinese judicial proceedings. Instead, Chinese courts would normally assess whether a transaction conducted by the Chinese counterparty violated any mandatory Chinese law.

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73 Article 42 of the Chinese Civil Law General Code
74 Article 10 of the Contract Law Interpretation (I)
Transactions entered into for hedging purpose in the course of a Chinese counterparty’s normal business operations should generally not be restricted or otherwise prohibited. A Chinese counterparty is likely to have ‘civil capacity’ to conduct derivative transactions for hedging purposes in the ordinary course of its business.

Importantly, if a Chinese counterparty however engages in a speculative derivative transaction (with no actual business exposure to the underlying assets), a Chinese court is highly likely to decide that the transaction is void unless:

- The counterparty is permitted to enter into derivative transactions for non-hedging purposes under the relevant Chinese laws or regulations; or
- Otherwise, the bank can demonstrate it is an innocent third party without notice of any speculative purpose (for example, by providing evidence that the bank performed reasonable due diligence and other appropriate assessments prior to entering into the transaction).

**Summary**

For the purpose of determining whether a derivative contract is invalid due to the lack of civil capacity, a lack of capacity does not necessarily invalidate the contract because:

- Chinese courts will assess whether the conduct of the Chinese company has exceeded its approved business scope (or for hedging of its approved businesses, if applicable), and has violated any mandatory regulations of Chinese law;
- If the conduct of the Chinese counterparty exceeds its approved business scope, the Chinese court may not invalidate the derivative contract especially when the bank was acting in good faith prior to entering into the contract; and
- If the conduct of the Chinese counterparty violates a mandatory regulation of Chinese law, Chinese courts will not uphold the contract.

**How Are Capacity Issues Examined In Chinese Judicial Practice? Implications For Pre-Execution Due Diligence Checks**

In most of the cases, defaulting Chinese counterparties alleged capacity issues as a defence. In other cases where a defaulting counterparty fails to appear in the proceedings, Chinese courts or arbitral tribunals may examine and decide that parties have capacity when making a default decision.

**SHIAC Arbitral Decision**

In a Shanghai International Economic and Trade Arbitration Commission (SHIAC) arbitral decision heard in 2016, the transaction involved copper forward trades between a foreign investment bank with a presence in China and a Chinese copper manufacturer. Although the

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75 For example, certain financial institutions including commercial banks in China are not subject to the hedging requirement

76 This case involved a dispute between a foreign-invested bank and a Chinese copper manufacturer
Therefore, it is always prudent to review a counterparty’s articles of association to identify any provisions that may restrict the counterparty’s ability to enter into derivative transactions.

A common question is whether a contractual representation (along the lines of the provisions similar to Section 3(a) of the ISDA Master Agreement) constitutes an adequate step for a bank to establish that a counterparty has the requisite approval and/or qualification to enter into a transaction. That kind of representation is useful and always recommended, but not sufficient.

Two critical factors that a party should address in dealing with a Chinese counterparty are:

- The type of the counterparty involved, and its primary business scope - for example, Chinese banks are subject to the China Banking Regulatory Commission (CBRC) licence requirements before they may conduct derivative business. There are similar licence and approval requirements for other non-bank Chinese financial institutions such as securities companies and insurance companies; and

- The categories of transactions - in particular, for counterparties that are only permitted to enter into derivative transactions for hedging purposes, whether the transaction is relevant to the counterparty’s approved business scope and is entered into to hedge its risk.

**Summary**

A party should verify its counterparty’s approved business scope by checking its articles of association and registration documents (such as its business licence). Generally, whilst the articles of association of non-financial Chinese entities would not normally include specific provisions relating to derivative transactions, the party should still evaluate whether hedging is relevant to the Chinese entity’s ordinary business activities as set out in its articles of association and/or business licence. The prevailing view in China is that derivative transactions for hedging genuine business risks should fall within a Chinese company’s business scope even if the articles of the company do not include express references to derivative transactions.
State Council Requirements For Overseas Futures Business Licence

The State Council has reiterated government policy that no person should enter into overseas futures businesses unless the person has obtained the required regulatory approval\(^\text{77}\). That policy is generally considered to be a mandatory provision referred to in Article 52 of the Chinese Contract Law (a breach of which invalidates the relevant contract). For example, import and export companies are required to seek approvals from the China Securities Regulatory Commission and the Chinese Ministry of Commerce before conducting overseas futures transactions for the purpose of hedging.

In the China Sugar case, a counterparty that did not have a licence for offshore futures business entered into exchange-traded futures.

China Sugar Case – Capacity Of SOEs

The plaintiff (ED&F) filed an application for the recognition and enforcement of an arbitral award granted by the London Sugar Commission. The defendant (China Sugar) argued the transaction was invalid because it lacked the capacity to enter into the contract because:

- It did not have the special foreign trade licence to import sugar; and
- It was not licensed to engage in offshore futures contracts.

The findings were that:

- Pursuant to instructions from China Sugar, ED&F opened futures trading accounts in New York to facilitate the derivative transactions in dispute, and engaged in speculative trading in substantial quantities of raw sugar futures for the purposes of making a profit;
- China Sugar had actual knowledge of all the futures trading activities of ED&F, and had benefited from profits made or reduced commodity prices; and
- China Sugar had traded through ED&F as its agent or directly in New York futures trading.

The SPC held that as a general rule, failure by a Chinese counterparty to obtain prior approval to engage in overseas futures business would invalidate the relevant futures transactions. The transactions violated mandatory Chinese law but the SPC allowed the recognition and enforcement of the arbitral award on the basis that a breach of mandatory Chinese law does not necessarily (and on the facts of this case, did not) jeopardize the public policy of China.

SASAC Notices

Certain types of Chinese corporates are subject to additional regulatory approvals before they can engage in transactions. In particular, central SOEs were previously subject to a ‘review-and-approval’ process implemented by the State-owned Assets Supervision and Administration Commission (SASAC)\(^\text{78}\).

\(^77\) The Circular on Further Clearance and Regulation of Futures Market, issued by the State Council and effective as of August 1, 1998

\(^78\) The previous SASAC requirement on ‘review-and-approval’ process has been removed by the Circular on Removal of Approval for Offshore Commodity Derivatives Business of Central State-owned Enterprises since 2015
**Liugong Case – SASAC Approval Of SOEs**

Citibank (China) Co., Ltd. (Citi (China)) entered into one US dollar/Polish złote spot and one US dollar/Polish złote forward transaction with Guangxi Liugong Co., Ltd. (a provincial SOE, Liugong). After negotiating with Liugong, Citi (China) set off the payments under the two trades that were due on the same settlement date and requested Liugong to pay the net amount to Citi (China). Liugong refused to make the payment.

Liugong argued:

- It did not obtain the approval from the SASAC;
- It did not fully comply with other obligations under the SASAC Notices; and
- It had not been duly authorized by its board to enter into the transactions.

The court rejected Liugong’s argument and clarified that the SASAC Notices only applied to central level SOEs but not at the provincial level. The court found that the transaction documents were signed by the person authorized under the authority provided by the CFO, CEO and Chairman of the board of Liugong. The court held that board approvals are internal corporate governance matters and should not affect the validity and effectiveness of the derivative agreement between the parties.

**CBRC Approval For Chinese Banks To Engage In Derivative Businesses**

A Chinese bank engaging in transactions is subject to the CBRC’s approval and supervision.

A Chinese counterparty may argue that the bank did not obtain the requisite derivative licence and allege a breach by the bank of its regulatory filing requirements as required by the CBRC regulations. Courts and arbitrators (particularly arbitrators in arbitration institutions in Shanghai and Beijing) will typically examine a Chinese bank’s licences and approvals granted by the CBRC (as well as the relevant branch’s filings with the local banking regulatory bureau).

**Liugong Case – Derivative Qualification Of The Bank**

The plaintiff and the defendant entered into a US dollar/Polish złote spot and a forward transaction. The defendant failed to make the net payment due and payable under the transactions.

The defendant sought to challenge the validity of the derivative contract on the ground of the plaintiff’s lack of CBRC approval.

The court rejected the defendant’s argument as the plaintiff was able to produce evidence that it had obtained the required approval to engage in derivative business.

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79 Although it is not clear in the judgment, it appears the Chinese court reached this conclusion because Citi (China) was able to rely on the authorisation provided by Liugong as a bona fide third party, in particular because the transactions were approved by the legal representative of Liugong. Under Article 50 of the Chinese Contract Law, actions taken by the legal representative of a Chinese legal person is valid and binding notwithstanding the person acted beyond the person’s approved powers unless the counterparty knows or ought to know the act of the legal representative is beyond powers.
A defaulting counterparty may also argue that the bank failed to complete a timely filing of the relevant product with the local CBRC. As illustrated in the Zhajiasu Highway case, it appears that this line of reasoning is unlikely to be upheld by Chinese courts.

Zhajiasu Highway Case – Delay In Cbrc Filing

Jiaxing Zhajiasu Highway Co., Ltd. (Zhajiasu) entered into a transaction with Industrial and Commercial Bank of China, Shanghai Bund sub-branch in June 2007. The sub-branch only completed the required filing with the local CBRC in September 2007.

Zhajiasu argued that the transaction was invalid because the branch had not obtained the requisite derivative licence when it entered into the transaction.

The court rejected Zhajiasu’s argument on the basis that:

• The Bank’s breach of the CBRC rules may not necessarily invalidate a contract as the CBRC rules are not mandatory requirements. The breach will only result in regulatory action against the party in breach, and

• Had Zhajiasu had any doubt in relation to the sub-branch’s licensing status, it should not have entered into the transaction or should have at least raised this issue with the Bank. Zhajiasu’s failure to do so indicated its tacit consent to the bank’s alleged lack of requisite qualification.

Although there are cases ruling that a mere breach of the Derivative Transactions Interim Measures by a Chinese bank should not invalidate a transaction because the Derivative Transactions Interim Measures are neither law nor an administrative regulation, it is general market practice to check if the Chinese bank (including each of its branches involved in any part of any transaction) has obtained the relevant derivative licence granted by the CBRC.

Summary

Parties should always check a counterparty’s:

• Articles of association, registration documents (such as its business licence) and any particular approval required by its regulator (for example, State Council, SASAC or CBRC) – however, failure to conduct any one or more of those checks will not necessarily result in a transaction being set aside by a Chinese court; and

• When the hedging requirement applies to a Chinese counterparty, whether the transaction hedges a risk incurred in the counterparty’s ordinary course of its business.
Signing Authority Of Representatives And Traders

Lack of corporate authority by the signatory or by a particular trader may result in the relevant master derivative contract and/or transactions not binding a counterparty. Parties should ensure that the persons representing the counterparty, including a signatory or trader, have obtained the necessary corporate authority and are exercising that authority within the scope of their authorisation.

In the Zhongmei case (summarized in the section in this paper headed How is a Transaction Concluded?), the court held that the transaction was invalid because the trade authorisation letter did not specify any authorized persons. The court dismissed the bank’s submission that it could rely on the principle that the employees representing the counterparty had ‘apparent authority’. The court cited the following facts:

• The relevant employees involved in the negotiation stage were employed by Zhongmei’s affiliated company only (not Zhongmei itself); and

• The employees indicated several times that they were not authorized to represent Zhongmei, and the bank was or should have been well aware of such fact.

Accordingly, the court held that the bank could not rely on the principle of ‘apparent authority’ because it was not acting bona fide.

Article 172 of the Chinese Civil Law General Provisions (and Article 49 of the Chinese Contract Law) recognize the validity of a contract where a bona fide counterparty relies on ‘apparent authority’. This may arise where a person who had no authority, or who had exceeded the scope of the person’s authority, or whose authority was revoked, nonetheless acted as if the person had such authority, and the counterparty had reason to believe that such person had authority to so act.

The decision in the Zhongmei case demonstrated that the key element necessary to establish ‘apparent authority’ is whether the counterparty had acted in good faith and without fault.

According to the Guiding Opinions of the SPC on Disputes over Civil and Commercial Contracts, the person who wishes to rely on ‘apparent authority’ bears the burden of proof, and this means it is necessary to prove there were facts that, when viewed objectively, prove that the person had acted in good faith and without fault in believing that the signatory or representative of a corporate counterparty had the authority to act on its behalf. The court will consider all the circumstances to determine if the person relying on ‘apparent authority’ had met its duty of reasonable care.

Another vitiating factor is the concept of ‘ultra vires’, where a legal representative exceeds the authorisation granted by the counterparty or by the counterparty’s articles of association. The legal representative of a Chinese company has general authority to act on behalf of the company, and such general authority covers the execution of contracts. A Chinese company bears the burden of proof in any allegation that the act or signature by its legal representative exceeded its authority. Article 50 of the Chinese Contract Law provides that if a legal representative of an entity enters into a contract that exceeds the representative’s authority, the entity is bound unless its counterparty knew or should have known that the legal representative was acting outside the representative’s authority.
Summary

In mitigating the risks concerning the lack of authority of counterparty’s representative, banks should require a counterparty to provide:

- Its corporate approval documents (including evidence of any internal delegation by the board to a relevant committee or business unit) approving its entry into the master derivative contract and the transactions;

- A document authorising a person (other than the legal representative) to sign the master derivative contract (this may be an authorisation signed by the legal representative or the board of directors);

- An authorisation such as a dealing mandate authorising certain persons to act on behalf of the counterparty (the authority might include: confirming the transaction terms, signing transaction request forms, giving verbal instructions and confirmations, signing trade confirmations, etc.); and

- Specimen signatures of all the counterparty’s authorized signatories and traders.
USE OF NON-INDUSTRY STANDARD LEGAL DOCUMENTS

General

As a general rule, parties are free to choose how to document a transaction. However, a NAFMII Agreement must be used to document OTC FX, rate, bond, gold and credit derivative transactions between two domestic inter-bank market participants.80

The usual approaches taken to document derivative transactions in China are summarized below:

<table>
<thead>
<tr>
<th>Derivative documentation</th>
<th>Governing law</th>
<th>Usual transaction types</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard documentation developed by the ISDA</td>
<td>English law/New York law</td>
<td>Transactions between a foreign bank and a counterparty</td>
</tr>
<tr>
<td>Standard documentation developed by NAFMII</td>
<td>Chinese law</td>
<td>Mandatory for OTC FX, rate, bond, credit and gold derivative transactions between two domestic inter-bank participants (including domestic banks, Chinese subsidiaries of foreign banks and Chinese branches of foreign banks, insurance companies, securities companies, fund management companies, credit unions and certain Chinese corporations etc). It is understood that some onshore banks also use the NAFMII Master Agreement to document OTC derivative transactions between a domestic bank and a corporate counterparty even if the agreement is not mandated for use in derivative transactions with a counterparty that is not a participant of the domestic inter-bank market.</td>
</tr>
<tr>
<td>2014 Master Agreement for OTC Derivatives Transactions and supplements prescribed by the SAC, China Futures Association and Asset Management Association of China82</td>
<td>Chinese law</td>
<td>Mandatory for OTC equity or fund derivative transactions between two Chinese securities companies or Chinese fund management companies, or OTC commodity derivative transactions between two Chinese futures brokerage companies.</td>
</tr>
<tr>
<td>Bespoke derivative documents (such as those developed by individual local banks)</td>
<td>Chinese law</td>
<td>Transactions between a Chinese bank and a Chinese corporate counterparty</td>
</tr>
</tbody>
</table>

Chinese courts will generally give effect to non-industry standard derivative contracts provided the documentation represents the parties’ genuine intention and does not violate any mandatory Chinese law or regulation. However, this will often vary from case to case (for example, the courts may look to other factors such as defects in the documents and the degree to which the documents deviate from industry standard).

In the Liugong case, the Guangdong High People’s Court enforced a bespoke derivative agreement and supported the trial court’s view that documentation for derivative transactions does not need to be in a standard master derivative contract to be enforceable.

The Liugong case is supported by other judgments in which bespoke derivative documents or mini-master agreements were recognized and enforced.83

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81 For a list of Chinese inter-bank market participants, please refer to http://www.nafmii.org.cn/hygl/hyfl/
82 See http://www.sac.net.cn/tzgg/201408/20140822_102261.html
83 See, for example: the Yingda case, the Golden Globe case, the Westlands case and the Fuchan case
Liugong Case – Formation Of Derivative Contracts

A US dollar/Polish złote derivative transaction was documented with a non-industry standard facility agreement, risk disclosure statements, trade authorisation, FX purchase and sales letter and FX transaction confirmation.

The defendant claimed the transaction was invalid because the parties should have entered into a separate standard derivative contract. Without a standard document, the defendant was misled and therefore, had an incorrect understanding of the nature of the transaction and the risks associated with the transaction.

The trial court noted the defendant failed to prove that the use of separate standard documents was a mandatory requirement under Chinese law, and held that the transaction was valid notwithstanding the lack of a separate standard derivative contract.

In dealing with a dispute over the enforceability of a derivative contract, Chinese courts may question the intention of the parties when dealing with bespoke derivative agreements and in construing specific terms used in those agreements, especially if the relevant agreement substantially deviates from the industry standard.

Summary

In the absence of bankruptcy proceedings, Chinese courts will generally give effect to non-industry standard derivative contracts provided the documentation represents the parties’ genuine intention and does not violate any mandatory Chinese law or regulation.

Recharacterisation Of Bespoke Master Derivative Contracts

A defaulting counterparty may challenge the legality of a master derivative contract that deviates from industry standard master derivative contracts (for example, by alleging the contract is in substance a wealth management agreement or an agency agreement). This is particularly the case if the deviation is substantial, with unclear drafting.

Where a contract is classified as a wealth management agreement or an agency agreement, the bank is subject to more onerous obligations (including fiduciary duties).

Westlands Case – Nature Of The Transaction Documents

Westlands Machinery (Zhuhai) Co., Ltd. (Westlands) and China Construction Bank, Zhuhai branch (CCB) entered into a deliverable US dollar/renminbi forward transaction under an FX/renminbi Forward Trade General Agreement (General Agreement).

Westlands failed to pay the US dollar amount to CCB on the settlement date and requested several extensions. CCB refused to further extend the forward transaction, closed out the transaction and paid a settlement amount to Westlands (which was in-the-money). Westlands however alleged that it was entitled to a much greater amount as the General Agreement
should be construed as an agency agreement whereby CCB was acting as the agent of Westlands to conduct the USD/FX forward business.

Westlands also argued that the relationship between Westlands and CCB under the General Agreement is comparable to the broker-client relationship, such that all losses should be assumed by, and all gains should be attributed to, the client, rather than the agent bank.

The trial court rejected Westlands’s argument. The court held that the transactions were entered into on a principal-to-principal basis, and the General Agreement and other documents were (in substance) a derivative contract (despite the use of words such as ‘entrust/agency’).

Although these arguments have not been supported by Chinese courts, it appears that certain words (such as ‘entrustment’, ‘for clients’ or ‘agency’) used in bespoke derivative master agreements may cause the party responsible for the drafting of the documents to be liable for a portion of the loss because it used misleading language.

**Summary**

It is preferable to use market standard master agreements in order to avoid claims by a counterparty that the derivative contract should be re-characterized as a wealth management product or that the bank is acting as the counterparty’s agent.

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84 The Chinese word used in the forward agreement is ‘委托’
CLOSE-OUT MECHANISM

Recognition Of A Single Agreement

Section 1(c) of the ISDA Master Agreement provides that the Master Agreement and all confirmations documenting the underlying transactions form a single agreement between the parties. This principle is also common across other derivative documents, such as the NAFMII Agreement, the SAC Agreement and some mini-master agreements. If the ‘single agreement’ concept is recognized in the bankruptcy proceedings of a counterparty, the administrator can either continue to perform, or terminate, all outstanding transactions, rather than ‘cherry pick’ the performance of specific Transactions.

Whilst the ‘single agreement’ concept is not expressly provided for in Chinese legislation, nor has it been specifically examined in a bankruptcy proceeding in Chinese courts, the latest regulatory developments and judicial views tend to endorse the ‘single agreement’ concept as a reflection of the contracting parties’ ‘freedom to contract’. The Shanghai Pudong People’s Court has published its view that in addition to the Chinese Contract Law provisions, Chinese courts should also consider prevailing industry standards and practices in the international derivatives market when dealing with derivatives disputes. Notably, it has received some judicial recognition (as illustrated in the cases below).

The recent Golden Globe case demonstrates the support of Chinese courts for the ‘single agreement’ concept in the context of a close-out termination of a master derivative contract between a bank and a counterparty.

Golden Globe Case – Single Agreement Concept

Citi (China) entered into a master derivative contract with the Shanghai Golden Globe International Trading Co. Ltd. (Golden Globe) and five separate transactions relating to copper traded on the London Metals Exchange.

Citi (China) requested Golden Globe to pay the required margin and to enter into an account pledge agreement. Golden Globe failed to do so, thereby triggering a termination event under the master derivative contract. Citi (China) delivered an early termination notice, specifying a date upon which all outstanding transactions would be deemed to be early terminated. Citi (China) later informed Golden Globe of the early termination amount that it failed to pay.

The Shanghai Pudong New Area People’s Court held that the derivative contract was an industry prescribed form and upheld the validity and effectiveness of its early termination provisions (including the close-out mechanism in respect of all outstanding transactions following an event of default or termination event). The court implicitly recognized and accepted the single agreement clause in the master derivative contract and applied a close-out netting process.

Although the Golden Globe case involved a contractual dispute over transactions entered into under a master derivative contract without consideration of the Chinese Enterprise Bankruptcy Law, this decision is indicative of judicial support for the ‘single agreement’ concept in the context of a master derivative contract in China (at least where there is no current bankruptcy proceeding).

85 The Shanghai Pudong People’s Court published 10 financial cases relating to Free Trade Zone business: http://www.pdfy.gov.cn/web2011/xxnr_view.jsp?pa=aaWQ9NzcxOTAmGg9MQPdcssPdcssz
This case demonstrates Chinese courts’ general recognition of the ‘single-agreement’ concept (in particular, where the provision aligns with standard industry documentation).

**Payment Netting**

Payment netting under derivative contracts is generally recognized by Chinese courts.

**Liugong Case – Payment Netting**

Citi (China) entered into one US dollar/Polish złote spot and one forward with Liugong under a mini-master agreement:

- Under the first transaction, Citi (China) Guangzhou branch was scheduled to sell an amount of Polish złote against a payment of US dollar to be paid by Liugong on the same settlement date; and
- Under the second transaction, Citi (China) Guangzhou branch was scheduled to buy Polish złote from Liugong to unwind the first transaction.

Citi (China) set off the payments due under the two transactions on the same settlement date and claimed the difference. Liugong argued there was no intention to set off the payments under the two transactions.

The Chinese courts (at first trial and upon appeal) recognized payment netting under the mini-master agreement. The Guangdong High People’s Court held that payment netting is a common settlement method to reduce settlement risk. In coming to its conclusion, the court held that the transaction records and trade confirmations signed by Liugong indicated the SOE’s agreement to payment netting. Liugong was found to have also mentioned ‘payment netting’ in correspondence after the second transaction was entered into, which again demonstrated that the parties reached an agreement on payment netting.

**Close-Out Netting**

Close-out netting is not a legal concept expressly recognized under Chinese law, nor is it expressly addressed under the Chinese Enterprise Bankruptcy Law. Nevertheless, Chinese courts are likely to apply the principle of ‘set-off’ under Chinese law to determine the enforceability of close-out netting. For an explanation on the enforceability of close-out netting, please refer to the ISDA memorandum on China close-out netting dated as of March 16, 2017.

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86 Close-out netting is a process comprised of three steps commenced by the Non-defaulting Party (or automatically upon the trigger of an Automatic Early Termination) under an ISDA Master Agreement following the occurrence of an Event of Default, namely: termination of all Transactions under the ISDA Master Agreement; valuation of the terminated Transactions; and determination of one single net amount payable under the ISDA Master Agreement.

87 Set-off is a legal right or principle that permits a debtor to discharge its debt by setting off a cross-claim owed to the debtor against its debt. Contractual set-off is not the only legal basis for the determination of one single net amount. Close-out netting and set-off are not functionally nor conceptually identical concepts.
A master derivative contract generally stipulates the calculation method for the early termination amount in situations where transactions are early terminated. For instance, Section 6 of the 2002 ISDA Master Agreement governs the valuation of terminated transactions and the determination of a net balance if an early termination date occurs.

Enforceability of close-out netting in respect of multiple transactions entered into under a master netting agreement upon bankruptcy of a Chinese counterparty has not been tested in a Chinese court88. However, the Chinese courts have expressly upheld the close-out netting and payment netting provisions as a matter of contract, as illustrated in the Golden Globe case and the Yingda case.

**Golden Globe Case – Close-Out Netting Provisions**

Citi (China) and Golden Globe entered into five LME copper swaps under a master derivative contract in the period from September to December 2014. The first transaction expired on December 22, 2014, but the company failed to pay the settlement amount.

In December 2014, Golden Globe failed to sign an Agreement of Pledge over Account and did not post the required margin to Citi (China). In addition, a loan advanced by Citi (China) Shanghai branch to Golden Globe was accelerated in late 2014. Those events constituted events of default under the mini-master agreement and Citi (China) served an early termination notice to close out four outstanding transactions, designating December 24, 2014 as the early termination date for the outstanding transactions.

Citi (China) determined the ‘close-out amount’ in respect of each early terminated transaction. Citi (China) was ‘in-the-money’ in respect of three transactions and the ‘out-of-the-money’ party for the fourth transaction. When determining each close-out amount, Citi (China) adopted quotations from a third party.

Citi (China) calculated a single net amount by setting off the four close-out amounts and the unpaid settlement amount in respect of the first transaction.

The calculation was upheld by the Shanghai court. The court was satisfied that the calculation of the early termination amount was made in good faith and in a commercially reasonable manner, and based on the fair market value of the terminated transactions.

**Yingda Case**

The Yingda case involved a dispute over a mini-master agreement between Citi (China) and Yingda Life Electric (Zhongshan) Co., Ltd. (Yingda). The parties entered into a USD/RMB forward. The parties were scheduled to exchange US dollar and renminbi amounts on five different settlement dates. However, before the occurrence of any settlement date, the defendant, Yingda, defaulted.

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88 A Chinese bankruptcy case against GITIC involved a dispute over a cross-border swap transaction documented under the 1987 version of an ISDA master derivative agreement. The case was heard by the Guangdong People’s High Court pursuant to the Interim Version of the Chinese Enterprise Bankruptcy Law as of 1986. Although the Chinese court and the bankruptcy committee did not challenge the effect of an automatic early termination of the master derivative agreement, the dispute involved only one transaction entered into under the master derivative agreement, and that the foreign counterparty’s claim for the settlement amount calculated pursuant to such agreement was rejected by the court. It is arguable that the GITIC case is not relevant to indicate how a Chinese bankruptcy court would analyze the closeout netting concept in bankruptcy proceedings.
There is growing judicial support in China for:

- Recognition of the ‘single agreement’ concept;
- Payment netting; and
- Close-out netting exercised in the absence of bankruptcy proceedings.

Potential Challenges Unique To China

A defaulting counterparty may challenge the amount claimed (primarily in relation to the close-out amount) based on grounds that are less common in other jurisdictions.

Common Arguments Made About The Close-Out Amount

A counterparty may argue that:

- A close-out amount is in the nature of compensation for losses⁸⁹, which should not be awarded if there is no proof of the actual loss suffered by the non-defaulting counterparty.

These allegations are usually made with respect to Article 113 of the Chinese Contract Law, which provides that the total compensatory amount shall equal the total loss sustained by a party due to the breach of contract⁹⁰;

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⁸⁹ In Chinese phrase, ‘损害赔偿’.

⁹⁰ Article 113 of the Chinese Contract Law provides: ‘Where one of the parties does not perform a contractual obligation, or does not perform a contractual obligation as agreed, resulting in losses to the other party, the total compensatory amount shall be equivalent to the total losses sustained by the other party due to the breach of contract, including benefits that the other party would have been able to obtain upon the contract being performed, but this amount shall not exceed the total losses that the breaching party, at the time of concluding the contract, foresaw or should have foreseen to probably result from breach of contract. Where business operators engage in fraudulent behaviour with respect to consumers in the provision of goods or services, they shall be liable to provide compensatory amount in accordance with the provisions of the Law of the People’s Republic of China on the Protection of the Rights and Interests of Consumers’
• The early termination amount constitutes ‘liquidated damages’ under Chinese law, which must not exceed 130% of the actual loss because Article 114 of the Chinese Contract Law and Article 29 of the Contract Law Interpretation (II) provide that:
  ○ Parties may reach an agreement on the liquidated damages or on the method for calculating the compensation for losses, provided that if the liquidated damages are excessively greater than the actual loss, a party may request the court or the arbitral tribunal to reduce the liquidated damages; and
  ○ Any liquidated damages exceeding 130% of the actual loss could be regarded as being ‘excessively greater’, and subject to reduction.

In the 2017 CIETAC Beijing Arbitration decision, the defaulting party to an ISDA 2002 Master Agreement governed by Chinese law alleged that the early termination amount calculated under Section 6 of the ISDA Master Agreement constituted liquidated damages for the purpose of Article 114 of the Chinese Contract Law. The party subsequently alleged that the amount was ‘excessively greater than the losses caused’ as a result of a breach of that agreement, and petitioned the relevant arbitral tribunal to reduce the liquidated damages. That argument was not accepted by the tribunal;

• Upon the early termination of transactions, the contract is discharged. Any obligation that has not been performed does not need to be performed. The non-defaulting party is obliged to take measures to prevent any increase in the losses suffered.

Under Articles 97 and 119 of the Chinese Contract Law:
  ○ After a contract has been discharged, the performance of any obligations that have not been performed is terminated. Where obligations have already been performed, depending on the status of performance and the nature of the contract, a party may demand to be put in the position as if no contract were entered into or resort to other remedies, and a party may also demand compensation for any losses sustained; and
  ○ The non-defaulting party must take measures to prevent any increase in the losses sustained, failing which it may not demand compensation for any increase in the losses sustained.

91 In Chinese phrase, ‘违约金’
92 References to ‘liquidated damages’ in this paper are used and should be construed in accordance with Chinese law, which may be different from the ‘liquidated damages concept’ under English law. While it is generally accepted that the early termination amount under the ISDA Master Agreement constitutes liquidated damages under English law, in the context of Chinese Contract Law analysis, the early termination amount should not be construed as the Chinese law’s concept of ‘liquidated damages’. This paper only examines the nature of the early termination in the context of Chinese law.
93 Please refer to the section in this paper headed ‘Nature of the early termination amount – ‘Liquidated Damages’ Or ‘Calculation Method For Compensatory Amount For Losses?’
94 Article 97 of the Chinese Contract Law
95 Article 119 of the Chinese Contract Law
Summary

In summary, Chinese law requires that liquidated damages (the compensatory amount for losses) should be substantially equivalent to the actual losses suffered by the non-defaulting party, and that party bears the burden of establishing the quantum of its losses.

Although Chinese law allows parties to agree on the quantum of liquidated damages to be paid for a breach of contract, a Chinese court will determine the actual losses to assess whether the liquidated damages are excessive (an amount is generally deemed to be excessive if it exceeds the actual loss by 30% or more).

Whilst the defaulting party bears the initial burden of proving that the liquidated damages are excessively greater than the actual loss, the burden of proof shifts to the non-defaulting party to prove its actual loss. A bank may find it difficult to prove that an early termination amount equals its actual loss, because:

- Even though the bank may claim that the early termination amount is based on calculations made with reference to third-party quotations, a Chinese court may find that the quotations are not directly linked to the bank's actual loss;

- The early termination amount may be calculated based on the loss that the bank has incurred in back-to-back transactions entered into with other counterparties to hedge its exposure under the defaulted derivative contract. However, since the bank has some flexibility in managing its exposure to transactions, the bank may not be able to accurately identify which hedging transactions are related to transactions entered into with the defaulting counterparty;

- Even if the bank can specifically identify the back-to-back transactions that are related to the transactions entered into with the defaulting counterparty, the defaulting counterparty may argue such losses do not reflect the bank's loss from the transactions entered into with the defaulting counterparty, but rather the bank's losses on the back-to-back transactions; and

- There are operational costs to the bank in providing hedging transaction services to the defaulting counterparty by arranging and performing derivative contracts (such as operational costs incurred to realize and manage transactions, as well as the costs to the bank of managing its own risk and entering into back-to-back transactions with third parties); however identifying, quantifying and proving such operational costs may not be feasible.

Chinese judges may proactively seek more information about a transaction and the contract in dispute, including evidence as to whether and how the parties performed their respective obligations under the transaction. That evidence may include documents exchanged during the pre-contract negotiations, written trade orders, transaction confirmations and the records held by a bank.

96 A defaulting party may also allege as a litigation strategy that the bank must prove that it has performed its obligations before it is entitled to claim the early termination amount following an early termination of the derivative transaction. The logic is there should be no loss if there has been no performance
Liugong Case – Performance Of A Derivative Contract

The parties entered into US dollar/Polish złote transactions. After a few extensions of the settlement date, Liugong and Citibank agreed to unwind a forward transaction by entering into a further spot and a further forward transaction.

After payments under the two transactions were netted off and a single amount was claimed by Citi (China), Liugong argued that since it had not performed its obligation to pay the US dollar amount to Citi (China) in exchange for Polish złote under the first USD/PLN transaction, the transactions had never been performed and so there should be no losses suffered by the bank.

The court rejected Liugong’s argument. The court found that, prior to the original settlement date for the first US dollar/Polish złote transaction, Liugong requested several extensions and after Citi (China) offered two options to Liugong (one being to settle the first transaction by gross payments, and the other being to unwind the transaction by entering into a second transaction, where only a single amount in US dollar netted from the two transactions would be paid), Liugong accepted the second option. The court held that this demonstrated performance of the agreement.

Chinese courts will generally not require extensive evidence as to whether there has been actual performance of a particular transaction – Chinese courts usually require electronic records to be produced by a bank to demonstrate the bank’s actual performance.

There have been cases where local courts at the city level, in examining an application not to enforce a domestic arbitral award, relied only on submissions by a defaulting counterparty as a basis to require the bank to prove its actual performance and provide evidence about the hedge entered into by the bank. Failure to do so during the arbitration proceedings was tantamount to the bank concealing evidence and so the relevant arbitral award granted to the bank was unfair and not enforceable.

Nature Of The Early Termination Amount - ‘Liquidated Damages’ Or ‘Calculation Method For Compensation Of Loss’?

An early termination amount constitutes either compensation for loss or the Chinese legal concept of ‘liquidated damages’.

Irrespective of the different analysis, there is a general judicial practice not to regard the early termination amount as liquidated damages (which is subject to a quantum limitation) but rather as a settlement mechanism based on fair market valuation. The fair market valuation mechanism may operate as a settlement mechanism in the derivative contract or a method of calculating the compensatory amount for the losses of a party, each is summarized below.

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97 See the section in this paper headed Enforcement of Domestic Arbitral Awards for enforcement process of the 2016 CIETAC Shanghai Arbitration decision. The implementation of the Arbitration Review Provisions should result in different court approaches being aligned and deviations minimized.

98 See the Golden Globe case.
Performance Of The Settlement Mechanism In The Derivative Contract

A school of thought is that, although the transactions have been terminated early, the master agreement still exists and is valid. According to this view, Section 6(e) of the ISDA Master Agreement operates as a settlement and clearance mechanism that remains effective after the termination of the transactions, rather than as a liquidated damage clause resulting from default under the contract.\(^9\)

In the 2017 CIETAC Beijing Arbitration decision,\(^10\) the tribunal held that ‘liquidated damages’ only applies to an event of default, whereas the early termination provisions under the ISDA Master Agreement are not ‘default’ based or triggered, and have the following features:

- The early termination provisions are designed to preserve the parties’ rights and obligations as if the relevant transactions were to continue in accordance with the contract, which is a different concept from the ‘discharge of contract’ provisions under Article 97 of the Chinese Contract Law;
- It is triggered upon the occurrence of certain non-default based events known as ‘Termination Events’ (e.g. Illegality, Force Majeure Event, etc.);
- The early termination amount is potentially payable by either party (rather than the defaulting party only). Section 6 of the ISDA Master Agreement provides that if the early termination amount is a positive amount, it will be paid by the Defaulting Party to the Non-defaulting Party, whereas if it is a negative number, the absolute value will be paid by the Non-defaulting to the Defaulting Party. The fact that Section 6 contemplates that even a Non-defaulting Party may be required to pay the defaulting party is inconsistent with the normal characterisation of ‘liquidated damages’ under the Chinese Contract Law as a payment from a defaulting party to the non-defaulting party; and
- The method for determining the early termination amount as set out under Section 6 of the ISDA Master Agreement reflects an agreement between the parties as to their obligations under the transactions after the occurrence of an early termination date, which is different to a provision for ‘liquidated damages’ that merely sets out the obligations of the parties for breach of the agreement.

A Method Of Calculating A Compensatory Amount For Losses

An alternative view as to the legal nature of the early termination amount is that:

- It should be classified as an amount payable after a discharge of a transaction;
- It is an entitlement permitted under the Chinese Contract Law to the parties’ reasonable anticipation of the extent of the liabilities arising from the discharge of transaction(s); and
- It should be adopted because it is prescribed under industry standard master agreements that follow international practice for derivative contracts, and do not conflict with any mandatory laws and regulations of China.

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\(^9\) Article 99 of the Chinese Contract Law provides that: ‘the discharge of the rights and obligations under a contract does not affect the effectiveness of the settlement and clearance clauses of the contract’

\(^10\) In this case, the defaulting party to an ISDA 2002 Master Agreement governed by Chinese law alleged that the early termination amount calculated under Section 6 of the ISDA Master Agreement constituted the liquidated damages for the purpose of Article 114 of the Chinese Contract Law. The party subsequently alleged that the amount was ‘excessively greater than the damage caused’ as a result of a breach of agreement, and petitioned to the relevant arbitral tribunal to reduce the compensation amount under Article 114 of the Chinese Contract Law and the relevant judicial interpretation
In the 2016 CIETAC Shanghai Arbitration decision, the tribunal held that, the early termination provision under the Chinese law governed ISDA Master Agreement was valid because it provided a method for calculating the amount of compensation for losses under the Chinese Contract Law.

The tribunal held that, in determining the early termination amount, the bank had a contractual right to reference market quotations or to rely on its actual unwind price. The bank only used the actual unwind price to calculate the early termination amount. The tribunal held, however, that the bank should rely on the more objective market quotation prices (rather than the actual unwind prices) to determine the early termination amount. The tribunal therefore made minor reductions to the calculation of the early termination amount.

However, there have been cases and awards where the courts and arbitration tribunals adjusted the early termination amount due to gaps or flaws in a bank’s evidence supporting its calculation of the early termination amount. A bank should therefore collate all its supporting evidence in obtaining third-party price quotations when determining the close-out amount(s) to demonstrate the calculation is undertaken in a commercially reasonable manner.

**Summary**

Chinese counterparties are unlikely to succeed in arguing that an early termination amount is subject to review as liquidated damages (which is subject to a quantum limitation).
MIS-SELLING CLAIMS AND PRE-TRADE REQUIREMENTS

MIS-SELLING CLAIMS

A series of cases indicate three common types of mis-selling claims by counterparties in onshore disputes:

- Misunderstanding the bank’s role as an investment adviser to the counterparty;
- The bundling of bank services or products with transactions; and
- Mis-selling by the bank (including misrepresentation of transaction risks).

Misunderstanding Of A Bank’s Role

A common allegation is that transactions were entered into in reliance on bank’s investment advice, which was misleading and did not meet the counterparty’s commercial intention. These claims are made despite standard contractual representations as to ‘non-reliance’ and ‘principal dealing status’ in the standard ISDA Master Agreement, and similar clauses in NAFMII Master Agreement. For example:

- **Lai Jianping case:** Mr Lai alleged that he was misled by a director of ABN AMRO’s Hong Kong branch and thought the bank was his financial advisor. As a result, he viewed his transaction with the bank as a wealth management product designed to generate stable income by using a discounted price to acquire certain stable and reliable stocks.

- **Haisheng Juice case:** Haisheng Juice alleged that MSAL had acted in its capacity as a credit advisor in facilitating Haisheng Juice entering into swap transactions with MSIP, and that there was mis-selling on the part of Morgan Stanley.

- **Liugong case:** The defendant Liugong alleged that it had been misled by Citi (China) Guangzhou branch, that the bank was acting as its agent and adviser and had failed to make adequate disclosure about the transaction risks.

A Chinese court will generally rely on submissions and supporting documents to determine if there had been any misleading conduct by a bank. The Guangzhou court in the Liugong case accepted:

- A risk disclosure statement provided by Citi (China) to Liugong during the transaction negotiation evidenced adequate disclosure about the relevant product’s risks; and
- The parties understood their legal relationship as transaction counterparties, rather than as an investment advisor or as an agent.

The court in the Fuchan case held that:

- The bank had used expressions and phrases such as ‘for client’, ‘entrustment’ or ‘(bank’s) payment in advance on behalf of the client’ in its documentation with the counterparty and misled its counterparty as to the legal relationship between the parties;

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101 Article 49 of the Derivative Transactions Interim Measures provides that a bank shall not mislead its clients through exaggeration of the derivative transaction’s upside.
• The bank’s risk disclosure document was unclear and generic without specific disclosure relating to the specific transaction, which did not satisfy the regulatory requirements under the Derivative Transactions Interim Measures; and

• The bank contributed to its loss and therefore bore 35% of its loss.

**Bundling Of Products/Services**

A bank must avoid forcing a client to enter into a transaction as a condition to making available other services and products\(^{102}\).

In the 2016 CIETAC Shanghai Arbitration decision\(^{103}\), the CIETAC held that the restriction on ‘bundling’ activities should focus on the restriction against any ‘mandatory bundling’, which is distinguished from normal business referrals across different sectors of a bank\(^{104}\). The tribunal decided the counterparty had entered into three separate derivative transactions after signing the master derivative contract that demonstrated the transactions were not bundled with an earlier loan transaction.

**Mis-Selling Conduct**

An article in September 2009\(^ {105}\) reported that a number of SOEs, which had suffered significant losses, sent letters to their foreign counterparties threatening to cease performance under their transactions. It was claimed that SASAC thought some products were sold fraudulently or without full disclosure of the relevant risks in reliance on provisions such as the Derivative Transactions Interim Measures, which require a bank to conduct suitability assessment on each counterparty and disclose the relevant risks during the marketing and selling process.

Most of the mis-selling cases involve the sale of wealth management products\(^ {106}\) to individual investors by Chinese banks but these cases by analogy indicate there are risks for Chinese banks when entering into transactions with corporate customers. These risks are reflected in the Hu Xiangbin case and Zhang Zhuqing case summarized below.

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102 Article 50 of the Derivative Transactions Interim Measures

103 The Chinese chemical manufacturer entered into a master derivative agreement with the bank following discussions regarding loan arrangements with the local branch. The bank then entered into transactions with the counterparty. The Chinese counterparty argued that the transactions were bundled to the loan arrangement and it did not understand the risks associated with and the commercial terms of the transactions.

104 The tribunal also found other factors showing that (i) the bank had sent multiple reminders to its counterparty to early terminate the transactions to stop further losses under volatile market conditions (as evidenced by various telephone recordings); and (ii) the representative of the counterparty had expressly confirmed its intention to continue with the transactions and the counterparty’s ability to sustain the potential losses


106 Chinese law does not expressly define what constitutes bank wealth management products, but it is generally understood to refer to wealth management products that banks develop and sell to specific client groups, whereby investors entrust their funds to the bank to manage, and the parties distribute the profits and losses as agreed in the contracts. Financial derivative products were initially considered by many to be a type of wealth management product, but, as a deeper understanding of these derivative products developed, the Chinese courts have made clear in a number of cases that the legal relationship for financial derivative products is different from the legal relationship for entrusted wealth management. In addition to cases discussed in the section in this paper headed Recharacterisation of Bespoke Master Derivative Contracts, courts have specifically noted that: (a) derivative products are different from entrusted wealth management because the client is not always required to deliver funds to the bank at the start of a derivative transaction, and (b) derivative transactions are unlike entrusted wealth management where the contracts may be terminated at any time.
Hu Xiangbin Case – Mis-Selling

The Hu Xiangbin case involved an investment contract for third-party financial products (being an asset management plan, WM Product) entered into between Mr Hu Xiangbin as the principal investor, Dacheng Fund Management Co., Ltd as the asset manager, and Bank of China Limited (BOC) as the asset custodian. In addition to its role as the custodian, BOC also completed Mr Hu’s risk assessment. The assessment report showed the WM Product was not suitable for Mr Hu, but Mr Hu signed the risk disclosure statement and BOC distributed the WM Product to Mr Hu. Mr Hu suffered significant loss and filed a claim against BOC.

BOC argued it only acted as the distributor/agent for the WM Product issuer (being Dacheng Fund Management Co., Ltd.), and should not be held responsible for Mr Hu’s loss.

The Shanghai No.1 Intermediate People’s Court found that normally a distributor would not conduct an investor risk assessment or suitability test, and, having done so BOC acted as a provider of financial services to Mr Hu and should assume responsibility in accordance with the Guidelines on Risk Management for Wealth Management Business for Individuals issued by the CBRC. BOC was responsible because it did not conduct suitability assessment in relation to the WM Product but rather relied on its prior general risk assessment.

The court held that BOC’s misconduct caused Mr Hu’s loss and was therefore liable for the loss incurred by Mr Hu in tort.

Zhang Zhuqing Case – Mis-Selling

The Qingdao Intermediate People’s Court held that, by promoting gold products with deferred settlement terms (T+D gold products) to Zhang Zhuqing, Ping An Bank Co., Ltd (Ping An Qingdao) had created a legal relationship with Zhang in relation to its wealth management advisory service. Ping An Qingdao was therefore required to conduct investment suitability test, risk assessment, risk disclosure and proper promotion of the T+D gold products.

Key findings were that Ping An Qingdao:

- Had proactively recommended the T+D gold products to Zhang even though the products were high-risk and that other clients who had invested in the products had suffered substantial losses; and

- Had breached the Guidelines on Risk Management for Wealth Management Business for Individuals issued by the CBRC.

Ping An Qingdao was ordered to compensate Zhang for his loss in the amount of 500,000 renminbi.

Although the facts of the Hu Xiangbin case and Zhang Zhuqing case are distinguishable in that they rely on measures and guidelines that aim to protect individual investors, the principles considered by the courts are likely to apply to derivatives disputes with clients to which suitability requirements apply.
In particular:

- Despite the absence of any contract or agreement, the process whereby a financial institution promotes or sells financial products to a client may, as a matter of fact, give rise to a legal relationship with its client;

- The financial institution's duties and obligations arising from such legal relationship will be determined by the applicable regulatory guidelines;

- There exists unequal knowledge between a financial institution and its client. A client does not generally possess professional investment knowledge to be able to assess whether a financial product is suitable. A financial institution must:
  - Select simple and suitable financial products for clients and avoid losses arising from a client's lack of investment knowledge; and
  - Not be reckless in introducing unsuitable financial products for which the only focus is the institution's own profit;

- The guidelines/directives issued by the CBRC reflect the civil law principles of fairness and the contract law principle of good faith. In the absence of clear rules and regulations, directives are referenced in defining the scope of a financial institution's rights and obligations, and whether the financial institution has breached its duties and obligations; and

- The fact that a client has signed a risk disclosure statement does not exempt a financial institution from its regulatory duty to make suitable recommendations.

**Summary**

In order to avoid the claim that a transaction was mis-sold, a bank should:

- Make clear it is not providing advice;
- Disclose the transaction risks;
- Avoid making the provision of other services or products conditional on entering into transactions; and
- Ensure the transaction is suitable where the counterparty does not possess professional investment knowledge.
REGULATORY PRE-TRADE REQUIREMENTS

Chinese Banks: Compliance With The Regulatory Requirements Under The Derivative Transactions Interim Measures

Most claims about a breach of regulatory obligations by a Chinese bank relate to the following requirements under the Derivative Transactions Interim Measures:

- Articles 29 and 31 of the Derivative Transactions Interim Measures - due diligence about the legal status of its clients and the transaction. A Chinese bank is required to assess that an individual or a corporate counterparty has ‘genuine business needs’ for the relevant transaction, and that there should be a reasonable correlation between the underlying assets and the business liabilities of the counterparty. In discharging these requirements, a bank is generally able to rely on commercially reasonable standards and on written evidence or supporting materials provided by the counterparty.

- Articles 18, 44 to 46 of the Derivative Transactions Interim Measures – assess on an annual basis, the clients’ derivative experience and understanding of particular transactions.

- Article 48 of the Derivative Transactions Interim Measures – disclose and explain to the counterparty the risks associated with transaction providing the worst-case scenario analysis, and obtaining written confirmation from the counterparty that it received the risk disclosure statements and the case scenario analysis.

Therefore, before transacting with a Chinese counterparty, a bank should always conduct appropriate due diligence to:

- Assess the counterparty’s business background and its principal purpose for entering into a transaction so that it is able to demonstrate (in the event of any dispute) that the counterparty had a genuine commercial need to hedge its business risks.

- The actual and approved scope of the counterparty’s business to assess the legitimacy of the purpose for which the counterparty enters into the transaction.

- The case involved a dispute between a foreign-invested bank and a Chinese copper manufacturer. The manufacturer did not submit any response during the arbitration, but the arbitral tribunal examined whether the bank had conducted any due diligence investigation on the client and its genuine business need before entering into the derivative transactions.
**Consequences Of A Breach Of The Derivative Transactions Interim Measures And Other Regulations**

Non-compliance with the Derivative Transactions Interim Measures does not render the affected derivative transaction void under Chinese law.

**Liugong Case – Consequence Of Breach Of Derivative Transactions Interim Measures**

The Liugong case considered US dollar/Polish złote derivative transactions. The transactions were terminated early and after the application operation of close-out netting, a single amount was claimed by Citi (China). However, Liugong failed to make that payment.

Liugong argued that Citi (China) had failed to fully disclose the nature of, and the risks associated with, the transactions, and Liugong was misled to believe that Citi (China) was the agent and the advisor of Liugong. Such non-performance breached the Derivative Transactions Interim Measures, and rendered the derivative contract void.

However, the court stated that only a breach of:

- Laws published by the National People’s Congress and its standing committee; and
- Administrative regulations published by the State Council,

Invalidates a contract. The Derivative Transactions Interim Measures were neither laws nor administrative regulations and therefore, a breach of which should not affect the validity and effectiveness of the relevant derivative contract.

Non-compliance with the Derivative Transactions Interim Measures may expose a Chinese bank to a penalty and Chinese courts may take into account the extent of the bank’s compliance with the applicable Chinese laws and regulations (including the Derivative Transactions Interim Measures) when determining the amount of damages to be awarded. For instance, in the Fuchan case, the early termination amount claimed by the bank was reduced due to its failure to conduct an adequate suitability assessment of, and provide adequate risks disclosure to, its counterparty.

A Chinese client may cite any deviation of its bank’s conduct from CBRC regulatory obligations as a ground to challenge the validity of a transaction.

**Summary**

A bank must:

- Conduct counterparty due diligence and assess whether there exists a commercial reason supporting the need for a particular transaction;
- Assess whether the proposed transaction is suitable; and
- Disclose the risks associated with the proposed transaction.
# LAWS, CASES AND GLOSSARY

## CHINESE LAWS AND REGULATIONS

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**CHINESE CASE SUMMARIES**

**Brightfood**

On Hing Paper Company Limited, Lam Fung Yam and others v Fubon Bank (Hong Kong) Limited

(1) Trial: 德意志银行股份有限公司、德意志银行股份有限公司香港分行、德意志银行（中国）有限公司上海分行与光明食品香港有限公司金融衍生品种交易纠纷【上海市第一中级人民法院,（2016）沪01民初454号】

(2) Final: 德意志银行股份有限公司、德意志银行股份有限公司香港分行、德意志银行（中国）有限公司上海分行与光明食品香港有限公司金融衍生品种交易纠纷民事裁定书【上海市高级人民法院, （2018）沪民辖终6号】

**Facts**

Brightfood Hong Kong Limited (Plaintiff) entered into a 2002 ISDA Master Agreement with Deutsche Bank AG (DB) in September 2013, as well as various cross-currency swaps through DB’s Hong Kong Branch (DB HK Branch) in 2013 and 2014. Some of the swaps in 2014 were introduced by Deutsche Bank (China) Co., Limited, Shanghai Branch (DB (China) SH Branch) to DB HK Branch. DB, DB HK Branch and DB (China) SH Branch were collectively referred to as ‘Defendants’. In 2016, the Plaintiff filed a claim with the Shanghai No. 1 Intermediate People's Court to invalidate the cross-currency swaps entered into in 2014 on the ground that they were mis-sold to the Plaintiff. The Defendants then challenged the jurisdiction of the Shanghai court on the ground of forum non conveniens, but was unsuccessful. The Defendants appealed to the Shanghai High People's Court but the challenge was declined again.

**Issues And Decisions**

- **Is the ISDA clause an exclusive or non-exclusive foreign jurisdiction clause?**

  The Shanghai court examined the governing law and jurisdiction clause in the 2002 ISDA Master Agreement and held that it was a non-exclusive foreign jurisdiction clause because Chinese courts were not ‘Convention Court’ as defined under the 2002 ISDA Master Agreement.

- **Did the Shanghai courts have jurisdiction over the cross-border dispute?**

  The Intermediate Court confirmed its jurisdiction over the contractual dispute on the basis that DB (China) SH Branch was domiciled in Shanghai. The High Court concurred on the basis that DB has a representative office in Shanghai, establishing a competent jurisdiction for Shanghai courts to hear the case.

- **Was the Defendant's challenge based on the ground of forum non conveniens successful?**
The High Court held that:

- The Plaintiff’s onshore parent’s interest was very likely to be involved in the dispute;
- The fourth condition under Article 532 of the Civil Procedures Law Interpretation that ‘the case is not related to the interests of the state, citizens, corporations or other organisations of China’ was not satisfied.

The Defendants’ challenge to the Chinese court’s jurisdiction on the basis of *forum non conveniens* was dismissed.
China Sugar

E.D. & F. Man (Hong Kong) Limited v China National Sugar Alcohol Group Corporation

(1) Trial: ED&F曼氏（香港）有限公司申请承认及执行英国伦敦糖业协会于2001年8月6日作出的第158号仲裁裁决一案【北京市第一中级人民法院，案号不详】
(2) Inquiry: 北京市高级人民法院关于对ED曼氏（香港）有限公司申请承认及执行伦敦糖业协会第158号仲裁裁决一案的请示【北京市高级人民法院，（2003）京高法7号】
(2) Response: 最高人民法院关于ED&F曼氏（香港）有限公司申请承认和执行伦敦糖业协会仲裁裁决案的复函【最高人民法院，（2003）民四他字第3号】

Facts

In December 1994, China National Sugar Alcohol Group Corporation (Defendant) entered into a contract with E.D. & F. Man (Hong Kong) Limited (Plaintiff) with respect to raw sugar. The parties signed 19 supplements to postpone the settlement period. The Plaintiff opened a futures trading account on the New York Futures Exchange for the purpose of trading/dealing in raw sugar and the Defendant traded raw sugar futures contracts with the Plaintiff for speculative purposes.

In 1999, since the Defendant failed to provide letters of credit as required under the contract, the Plaintiff submitted the dispute to the London Sugar Commission (Commission) for arbitration, and claimed compensation calculated based on the difference between the futures price under the contract and the market price. In 2001, the Commission granted an arbitral award in favour of the Plaintiff.

The Plaintiff requested the Beijing No. 1 Intermediate People's Court to recognize and enforce the arbitral award. The Intermediate Court filed the case with the Beijing High People's Court. The High Court was minded to refuse to enforce the arbitral award granted by the Commission and submitted a further inquiry to the Supreme People's Court (SPC).

The SPC allowed the recognition and enforcement of the arbitral award.

Issues And Decisions

• Capacity of the Defendant to enter into the contract

When the Plaintiff asked the Beijing court to recognize and enforce the arbitral award granted by the Commission, the Defendant argued that the transaction was invalid because it lacked the capacity to enter into the contract because:

º It did not have the special foreign trade licence to import sugar; and
º It was not licensed to engage in offshore futures contracts.

The Beijing courts ruled that the Defendant, as an enterprise legal person, had the capacity to enter into the contract and the futures trades. The SPC disagreed and held that, as a general rule, the failure by a Chinese counterparty to obtain prior approval to engage in an overseas futures business invalidates the futures transactions.

• Whether the arbitral award should be recognized and enforced in China
The Beijing court, however, was of the view that the futures contracts were entered into, by the Defendant for speculative purposes, which violated mandatory provision under Chinese law and hence jeopardized public policy of China.

Whilst the SPC agreed that the Defendant violated mandatory Chinese law by entering into the contract and futures trades without obtaining the relevant approval, the SPC allowed the recognition and enforcement of the arbitral award on the basis that a breach of mandatory Chinese law does not necessarily (and on the facts of this case, did not) jeopardize Chinese public policy.
CITIC AUS

CITIC Australia Commodity Trading Pty Limited v Shanxi Coal Import & Export Co. Ltd. and others

(1) Trial: 中信澳大利亚资源贸易有限公司与山煤煤炭进出口有限公司、青岛德诚矿业有限公司管辖裁定书【山西省高级人民法院，(2014)晋商初字第8号】
(2) Appeal & final: 中信澳大利亚资源贸易有限公司与山煤煤炭进出口有限公司、青岛德诚矿业有限公司管辖裁定书【最高人民法院，（2016）最高法民终66号】

Facts

Shanxi Coal Import & Export Co. Ltd. (Plaintiff) submitted a contractual dispute to the Shanxi High People’s Court against CITIC Australia Commodity Trading Pty Limited (Defendant). CITIC AUS challenged the Shanxi High People’s Court’s jurisdiction, alleging that parties had agreed to the submission of disputes to the exclusive jurisdiction of the High Court of London.

The Shanxi High People’s Court dismissed CITIC AUS’ challenge on the basis that the objection period had expired. CITIC AUS then lodged an appeal to the SPC.

Issues And Decisions

The SPC held that the challenge was made within the objection period, but determined that the issue was the validity of the exclusive jurisdiction clause.

Although section 10 of the agreement required the parties to submit any dispute in connection with or arising from the agreement to the ‘exclusive jurisdiction of the English High Courts in London’, CITIC AUS did not provide the SPC with any evidence proving that the High Court of London had the requisite actual connection with the contract. Therefore, the SPC held that the exclusive jurisdiction clause was invalid pursuant to Article 531 of the Civil Procedures Law Interpretation.

As to whether the Chinese court should hear argument as to the validity and other merits of the underlying agreement, the parties were only engaged in a procedural dispute, and the court made the ruling based on the appearance of the materials submitted by the parties without any review in substance.

The contract was signed in Taiyuan, Shanxi. Accordingly, the Shanxi High People’s Court had jurisdiction over the dispute.
Facts

Foodchem International Corporation (Plaintiff) entered into the following documents for the purposes of an FX options trade (which included a US dollar/renminbi cap option):

- A facility letter (Facility Letter) dated June 15, 2015 with DBS Bank (China) Ltd., Shanghai Branch (Defendant);
- An NAFMII Master Agreement (2009 version) and the Supplement thereto (NAFMII Agreement) dated June 16, 2015 with the head office of the Defendant;
- A term sheet of the US dollar/renminbi cap option; and
- A trade confirmation (together with the NAFMII Agreement, the NAFMII Documents).

In 2016, the Plaintiff failed to pay an amount under the US dollar/renminbi cap option. The Defendant then submitted the dispute to CIETAC Shanghai sub-commission pursuant to the arbitration clause under the NAFMII Agreement (Arbitration Clause).

The Plaintiff subsequently filed the following requests with the Chinese courts:

- **(Foodchem case 1)** In July 2016, the Plaintiff filed a request with the Beijing No. 2 Intermediate People's Court to invalidate the Arbitration Clause. The request was dismissed.

- **(Foodchem case 2)** In September 2016, the Plaintiff applied to the Shanghai Pudong New Area People's Court to revoke the trade confirmation. The case was dismissed. The Plaintiff appealed to the Shanghai No. 1 Intermediate People's Court and the case was dismissed again. The Plaintiff requested a retrial before the Shanghai High People's Court but was rejected on June 22, 2017.

- **(Foodchem case 3)** In August 2016, CIETAC Shanghai sub-commission heard the dispute filed by the Defendant and granted an arbitral award in favour of the Defendant in November 2016. The Plaintiff filed a request to the Beijing No. 2 Intermediate People's Court to set aside the arbitral award, which was rejected by the Beijing court in June 2017.
Issues And Decisions

Foodchem Case 1 (Beijing No. 2 Intermediate People’s Court)

• Is the Arbitration Clause legally valid and binding?

   Yes. The court held that the Arbitration Clause was legally valid and binding on the basis that (i) the clause evidences the parties’ clear and unequivocal intention to submit disputes to arbitration, (ii) the clause clearly sets out the scope of dispute that was subject to arbitration, (iii) the clause selects a lawful arbitration commission, and (iv) the clause was not made in circumstances that might have rendered it invalid under the Chinese Arbitration Law.

• Given that the NAFMII Documents were entered into by the head office of the Defendant (rather than the Defendant), is the Defendant entitled to invoke the Arbitration Clause by bringing the dispute to CIETAC Shanghai sub-commission?

   The court deferred the ruling on this issue to the arbitral commission.

• Did the dispute resolution clause under the Facility Letter (which was inconsistent with the Arbitration Clause) supersede the Arbitration Clause?

   The Plaintiff tried to rely on an ambiguous jurisdiction clause in the Facility Letter, which, the Plaintiff argued, amended the Arbitration Clause.

   The court rejected the Plaintiff’s request and held that the Facility Letter was executed prior to the execution of the NAFMII Agreement, so it could not amend or conflict with the Arbitration Clause. Therefore, the Arbitration Clause was valid.

FOODCHEM CASE 2 (SHANGHAI COURTS)

The Pudong court agreed with the ruling of the Beijing Intermediate People’s Court and upheld the validity of the Arbitration Clause.

In upholding the validity of the Arbitration Clause, the Pudong court noted that:

• The Plaintiff should have known that a specific trade could be entered by any branch or sub-branch of the Defendant, even though the NAFMII Documents were signed by the head office of the Defendant only. As such, the Arbitration Clause bound the Plaintiff and the Defendant.

• As the dispute before the Pudong court was, in substance, same as the dispute submitted for arbitration by the Defendant, the court had no jurisdiction pursuant to the Chinese Civil Procedures Law.

The Pudong court dismissed the Plaintiff’s case.

The Plaintiff subsequently appealed to the Shanghai No. 1 Intermediate People’s Court and requested a retrial, but was rejected.
Foodchem Case 3 (Beijing No. 2 Intermediate People’s Court)

The key issue to be determined by the Beijing No. 2 Intermediate People’s Court was whether the CIETAC arbitral award should be set aside. The court rejected the Plaintiff’s request to set aside the arbitral award and upheld the CIETAC arbitral award.

In particular, the court rejected the following arguments made by the Plaintiff:

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<th>Plaintiff’s allegations</th>
<th>Court ruling</th>
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<tr>
<td>One of the arbitrators had an interest in the Defendant’s case (and therefore had a conflict of interest)</td>
<td>Rejected on the basis that there was no evidence to support this allegation</td>
</tr>
<tr>
<td>The Defendant concealed evidence that would have adversely affected the result of the arbitration proceeding</td>
<td>Rejected on the basis that the Defendant had provided the relevant materials and documents to the CIETAC and the Plaintiff failed to provide sufficient evidence to support its allegation</td>
</tr>
<tr>
<td>The CIETAC made mistakes in finding the facts and applying the relevant laws</td>
<td>Rejected on the basis that there was no evidence to support this allegation</td>
</tr>
<tr>
<td>The arbitral award violated the public interest of China because the Defendant engaged in illegal activities by entering into the trades (namely conducting gambling activities in China and manipulating renminbi/FX rates)</td>
<td>Rejected on the basis that the case did not involve any public interest (but was a mere private matter). In any event, the court found the gambling and RMB/FX rate manipulation allegations to be unfounded</td>
</tr>
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</table>
### Fuchan

Shaoxing Fuchan Home Textile Co., Ltd. v Agricultural Bank of China, Shaoxing Keqiao Sub-branch, etc.

(1) Trial: 绍兴市福禅家纺有限公司与中国农业银行股份有限公司绍兴柯桥支行、中国农业银行股份有限公司绍兴分行金融衍生品种交易纠纷一审民事判决书【浙江省绍兴市中级人民法院，（2015）浙绍商外初字第8号】

(2) Final: 绍兴市福禅家纺有限公司与中国农业银行股份有限公司绍兴柯桥支行、中国农业银行股份有限公司绍兴分行金融衍生品种交易纠纷二审民事判决书【浙江省高级人民法院，（2016）浙民终339号】

### Facts


In September 2007 and January 2008, the parties entered into two US dollar/Japanese yen option trades:

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</thead>
<tbody>
<tr>
<td>Trade 1</td>
<td>September 10, 2007 On each settlement date:</td>
<td>On a quarterly basis</td>
</tr>
<tr>
<td></td>
<td>• If US dollar/Japanese yen ≥ 85, the Plaintiff buys $500,000 from the Defendants at a forward rate of 56; and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• If US dollar/Japanese yen &lt; 85, the Plaintiff buys $1,000,000 from the Defendants at a forward rate being (spot rate on trade date x 99.80/(average of five spot rates on five business days prior to the settlement date + 10)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deposit (margin) = 23.50 million renminbi</td>
<td></td>
</tr>
<tr>
<td>Trade 2</td>
<td>January 9, 2009 On each settlement date:</td>
<td>On a quarterly basis</td>
</tr>
<tr>
<td></td>
<td>• If US dollar/Japanese yen ≥ 84, the Plaintiff buys $500,000 from the Defendants at a forward rate of 60; and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• If US dollar/Japanese yen &lt; 84, then the Plaintiff buys $1,000,000 from the Defendants at a forward rate being (spot rate on trade date x 99.80/(average of five spot rates on five business days prior to the settlement date + 10)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deposit (margin) = 4.55 million renminbi</td>
<td></td>
</tr>
</tbody>
</table>

In October and December 2010, the Plaintiff sent termination notices to the Defendants but the notices were rejected by the Defendants.

The trades continued, but the Plaintiff failed to pay the relevant amounts due to the Defendants.

In December 2013 and January 2014, the Defendants served a cancellation notice on the Plaintiff to terminate the General Agreement.

In April 2014, the Plaintiff served notice requesting the Defendants to unwind the trades and return the deposits (margins) posted with the Defendants. The Defendants refused.
In 2015, the Plaintiff commenced an action in the Shaoxing Intermediate People’s Court. In April 2016, the trial judgment was issued and both parties appealed.

The Zhejiang High People’s Court heard the appeal case and affirmed the trial judgment.

**Issues And Decisions**

- **Nature of the dispute: a dispute over the agreement of agency or the derivative agreement**

  As a matter of substance, the General Agreement and the relevant transaction documents constituted a derivative contract because:

  - If it were an agreement of agency or a wealth management, the client should have had the right to discharge the contract from time to time at its sole discretion. The Plaintiff did not have such right under the transaction documents;

  - The transactions referencing the movements of the US dollar/Japanese yen rate were entered into by the parties on a principal-to-principal basis; and

  - The transactions were derivatives as defined under the Derivative Transactions Interim Measures.

  As such, the agreement and documents entered into by the parties constituted a derivative contract. That conclusion was unaffected by the fact that the General Agreement and the relevant transaction documents contained words such as ‘for client’, ‘entrustment’ or ‘(the Defendant’s) payment in advance on behalf of the client’.

- **Were the Defendants entitled to early terminate the transactions?**

  The court held that the Defendants were entitled to exercise, and had successfully exercised, early termination rights under the transactions.

  The transactions were foreign exchange options. Once the buyer paid the premiums, the seller of the options lost the right to early terminate the trades. Although the terms of the transactions did not provide for any premium payment, the Defendant paid the Plaintiff (as the option seller) four settlements amounts that were much higher than amounts commonly expected for such transactions. Therefore, the court held that the Defendants were entitled to exercise their early termination rights and the Plaintiff was not entitled to terminate the transactions unilaterally.

  As for the notices sent by the Plaintiff and the Defendants, since the terms of the General Agreement only permitted the Plaintiff to terminate the General Agreement by mutual agreement, the notices sent by the Plaintiff in 2010 had not successfully terminated the derivative agreement. The court therefore held that the Defendants successfully exercised their unilateral termination rights by serving the cancellation notices in December 2013 and January 2014.

- **Responsibilities of the parties**

  While the Plaintiff claimed the repayment of the deposits (margins), the Defendants counter-claimed for a compensation of approximately $3.59 million (being the balance of a total loss of around $8.06 million and the deposits (margins) of 28.05 million renminbi).
In determining the appropriate liability of the Plaintiff and the Defendants, the court held that the Plaintiff was an experienced investor and able to assume the transaction risks. Nevertheless, the court held that, taking into account the Defendants' performance and non-performance of various aspects of the transaction, the Defendant should also be responsible for a certain portion of the losses.

In particular, the court noted that:

- The Defendants failed to make full disclosure of risks associated with the trades, such as:
  - The Plaintiff was not informed that the General Agreement deviated from market standard international derivative documents.
  - The use of the words ‘entrustment’ and ‘for client’ did not correctly reflect the principal-to-principal relationship between the parties and was misleading.
  - At the time of concluding the derivative agreement, the Defendants did not provide detailed risk assessment (including the worst-case scenario analysis) to the Plaintiff, nor did they provide the relevant information about of the back-to-back hedging activities between the Defendants and the hedge counterparty, or the possible consequence of a unilateral termination of the transactions. A general statement that the client had acknowledged and was willing to assume the embedded risks was not sufficient for the purpose of complying the requirements under the Derivative Transactions Interim Measures.
  - When performing the transactions, the Defendants failed to provide the Plaintiff with the relevant market information or the market valuation results or the market risks on a timely basis.
  - The Defendants failed to provide the Plaintiff with the relevant trade confirmations that formed part of the General Agreement. In addition, the Defendants used the phrase ‘early termination (by mutual agreement)’ in the unilateral cancellation notices sent by the Defendants in December 2013 and January 2014, which was misleading and implied a mutual termination process instead of a unilateral cancellation exercise.
  - At the time the unilateral cancellation notices were sent by the Defendants, the US dollar/Japanese yen exchange rates favoured the Plaintiff. As such, the Defendants were not acting in good faith by unilaterally cancelling the transactions at that particular time (particularly because the Defendants had made considerable gains from back-to-back hedging arrangements).

The court held that the Defendants should be responsible for 35% of the losses they suffered.
Golden Globe

Citibank (China) Co., Ltd. v Shanghai Golden Globe International Trading Co., Ltd.

花旗银行(中国)有限公司诉上海金环球国际贸易有限公司等金融衍生品交易纠纷案【上海市浦东新区人民法院，（2015）浦民六（商）初字第52958号】

Facts

Citibank (China) Co., Ltd. (Plaintiff) signed a derivative transaction master agreement (Mini-master Agreement) with Shanghai Golden Globe International Trading Co. Ltd. (Defendant) in 2010. The Plaintiff and Defendant entered into five separate swap transactions relating to copper traded on the London Metals Exchange between September and December 2014.

A chain of defaults occurred in respect of the Defendant during 2014:

• The Defendant failed to pay the settlement amount in respect of the first swap transaction.
• In December 2014, the Defendant failed to sign the Account Pledge Agreement and did not post any required margin to the Plaintiff.
• A loan advanced by the Shanghai branch of the Plaintiff to the Defendant was accelerated at the end of 2014.

These events constituted ‘termination events’ under the Mini-master Agreement and the Plaintiff served an early termination notice to close out the four outstanding trades.

The Plaintiff calculated a single net amount and the unpaid settlement amount in respect of the first trade that terminated before the early termination date (being the ‘unpaid amount’ owed by the Defendant to the Plaintiff). The single net amount constituted the ‘early termination amount’ due and payable by the Defendant. The Defendant failed to make that payment.

The Plaintiff commenced action in the Shanghai Pudong New Area People’s Court.

Issues And Decisions

• Were the Mini-master Agreement and the trade confirmations legally valid and binding?

Yes. The court found that the Mini-master Agreement and the trade confirmations represented the parties’ genuine intention to create legal relations and did not violate any mandatory Chinese law.

• Was the Plaintiff’s calculation of the early termination amount valid?

Yes. The court upheld the validity and effectiveness of the early termination provisions under the Mini-master Agreement (including the close-out mechanism in respect of all outstanding transactions following an event of default or termination event, which was considered to be in line with the industry standards). The court was satisfied that the calculation of the early termination amount was made in good faith and in a commercially reasonable manner, and based on the fair market value of the terminated transactions.
Hu Xiangbin

Hu Xiangbin v Bank of China Limited, Shanghai Tianlin Road Sub-branch

(1) Trial: 中国银行股份有限公司上海市田林路支行与胡象斌、大成基金管理有限公司财产损害赔偿纠纷民事判决【上海市徐汇区人民法院，（2014）徐民二（商）初字第541号】
(2) Appeal: 胡象斌诉中国银行股份有限公司上海市田林路支行侵权责任纠纷案【上海市第一中级人民法院，（2015）沪一中民六（商）终字第198号】
(3) Acceptance for retrial: 中国银行股份有限公司上海市田林路支行与胡象斌、大成基金管理有限公司财产损害赔偿纠纷民事裁定书【上海市第一中级人民法院，（2015）沪一中民六（商）终字第198号】

Facts

The Hu Xiangbin case was first heard at the Shanghai Xuhui People's Court, and then appealed to the Shanghai No. 1 Intermediate People's Court, with the following key findings of fact:

• An investment contract for certain third-party financial products (being an asset management plan, the WM Product) was entered into between Mr Hu Xiangbin (Plaintiff) (as the principal investor), Dacheng Fund Management Co., Ltd (as the asset manager), and Bank of China Limited, Shanghai Tianlin Road Sub-branch (Defendant) (as the asset custodian);
• In addition to its role as the custodian, the Defendant completed a risk assessment of the Plaintiff;
• Although the assessment report showed that the WM Product was not suitable for the Plaintiff, after the Plaintiff confirmed and signed the risk disclosure statement, the Defendant promoted and distributed the WM Product to the Plaintiff.

The Plaintiff suffered significant loss in the WM Product and filed a claim against the Defendant for compensation.

Issues And Decisions

The trial court held that:

• The Defendant was not the issuer or designer of the WM Product, but just a distributor of the WM Product;
• The Defendant had requested the Plaintiff to sign the risk disclosure statement and fulfilled its obligation;
• The Plaintiff, as a citizen having full civil conduct capacity, should have the knowledge of the WM Product he invested in and the risks associated therewith;
• The Plaintiff failed to prove any misleading conduct during the distribution of the Defendant; and
• The Plaintiff’s claims were rejected.
The Plaintiff appealed to the Shanghai No.1 Intermediate People’s Court that reversed the trial judgment.

- **Relationship between the Plaintiff and the Defendant**

  The purchase of the WM Product by the Plaintiff was made in response to the Defendant’s promotion and in its office. The Defendant had conducted a risk assessment and disclosed to the Plaintiff the relevant risks in investing in the WM Product.

  However, in a pure distribution relationship, the distributor would not conduct an investor risk assessment or suitability test, and, having done so, the Defendant acted as a provider of financial services to the Plaintiff.

  Therefore, a legal relationship in respect of the financial services was established between the Plaintiff and the Defendant. The Defendant was not merely a distributor of the asset manager or a custodian, but a wealth management advisor to the Plaintiff.

- **Tort acts of the Defendant**

  In the wealth management advisory business, the advisor should comply with the relevant regulatory requirements, such as the requirements under the *Guidelines on Risk Management for Wealth Management Business for Individuals* issued by the CBRC. One of the requirements was that banks should not proactively promote or sell to the investors wealth management products not suitable to them.

  However, the Defendant did not carry out suitability assessment on the Plaintiff specifically in relation to the particular WM Product considered in the case. Instead, it only relied on a general risk assessment. Furthermore, even though the WM Product might not be suitable to the Plaintiff according to the general risk assessment, the Defendant proactively promoted the WM Product to the Plaintiff.

  In a financial service relationship, the bank should have much more knowledge and information than the individual investors. Therefore, the Defendant had more onerous obligations, for example, it was obliged to, inter alia,

  - comply with Article 23 of the *Guidelines on Risk Management for Wealth Management Business for Individuals* and Article 37 of the *Interim Measures for the Administration of Commercial Banks’ Personal Financial Management Services*;
  - provide correct assessments and suitable recommendations in recommending the wealth management product to individual investors pursuant to the *Interim Measures for the Administration of Commercial Banks’ Personal Financial Management Services*; and
  - not recommend relevant financial products to individual investors that were inconsistent with the investor’s assessment results on his/her risk tolerance level.

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109 Article 23 prohibits a commercial bank from recommending or selling investment products with high market risks to the customers who have no relevant trading experience or who are evaluated to be unsuitable for purchasing the relevant product.

110 Article 37 requires a commercial bank to inquire about a customer’s risk preference, risk perception capability and risk tolerance, evaluate the customer’s financial status, and provide suitable investment products when providing financial management consulting services to, and making recommendations of an investment product to, the customer.
In this case, the Defendant’s mis-selling breached the relevant regulatory requirements, it did not act in good faith, and its conduct constituted a tort.

- **Liabilities of the Defendant**

  The Defendant was liable for its inappropriate selling. The Plaintiff knew the WM Product was not suitable and so the Plaintiff was liable for part of his loss.

  The Plaintiff’s claim for return of the investment principal was allowed, but his claim for interest by way of compensation was rejected.

  The Defendant applied for a retrial and this case is currently pending further review.
Kolmar

Kolmar Group AG v Jiangsu Textile Industry (Group) Import & Export Co., Ltd.

Kolmar Group AG与江苏省纺织工业（集团）进出口有限公司申请承认和执行外国法院民事判决、裁定特别程序民事裁定书【江苏省南京市中级人民法院，（2016）苏01协外认3号】

Facts

Jiangsu Textile Industry (Group) Import & Export Co., Ltd. (Defendant) reached a settlement agreement with Kolmar Group AG (Plaintiff).

The Defendant failed to pay the Plaintiff in accordance with its obligations under the settlement agreement, as a result of which the Plaintiff commenced proceedings against the Defendant in the High Court of Singapore (being the court with jurisdiction pursuant the settlement agreement).

The High Court of Singapore gave a default judgment ordering the Defendant to pay the Plaintiff $350,000 together with interest. The Singaporean judgment was served on the Defendant but the Defendant did not respond.

The Plaintiff then applied to the Nanjing Intermediate People’s Court for the recognition and enforcement of the Singaporean judgment in China.

Issues And Decisions

The Defendant argued that the Singaporean judgment should not be recognized or enforced as there was no bilateral or international treaty between China and Singapore to recognize and enforce judgments rendered in the other country (and vice versa).

The court rejected the Defendant’s argument and recognized/enforced the Singaporean judgment on the basis that:

- There was reciprocity between Singapore and China. The court cited an earlier Singapore court decision in which the High Court of Singapore recognized and enforced a civil judgment issued by the Suzhou Intermediate People’s Court.

- The recognition and enforcement of the judgment granted by the High Court of Singapore would not violate the basic principles of Chinese law, state sovereignty, national security, or public interest of China.
**Lai Jianping**

Lai Jianping and others v ABN AMRO Bank N.V.

(1) Trial: 赖建平、刘祝平诉荷兰银行有限公司财产损害赔偿纠纷一案一审裁定书【上海市第一中级法院，（2010）沪一中民六（商）初字第6号】

(2) Appeal: 赖建平、刘祝平诉荷兰银行有限公司案二审裁定书【上海市高级人民法院, （2010）沪高民五（商）终字第49号】

(3) Retrial: 赖建平、刘祝平与荷兰银行有限公司财产损害赔偿纠纷案再审民事裁定书【最高人民法院, （2012）民申字第1104号】

**Facts**

In July 2007, Lai Jianping (Plaintiff) entered into the Individual Master Agreement for Trading Foreign Exchange and Structured Products (Mini-master Agreement) with ABN AMRO Bank N.V. (Defendant). The Mini-master Agreement contained, amongst others, the following jurisdiction clause pursuant to which the parties submitted to the jurisdictions to the Hong Kong courts (Jurisdiction Clause):

'(a) This Agreement will be governed by and shall be construed in accordance with English law;

(b) with respect to any suit, action or proceedings relating to any dispute arising out of or in connection with this Agreement and for the Bank's own benefit, each party irrevocably submits to the jurisdiction of the Hong Kong courts, waives any objection which it may have at any time to the laying of venue of any proceedings brought in any such court, waives any claim that such proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such proceedings, that such court does not have any jurisdiction over such party. Each party agree that the bringing of proceedings in any one or more jurisdictions will not preclude the bringing of proceedings in any other jurisdiction.'

The Plaintiff entered into certain Knock-out Discount Accumulator (KODA) contracts with the Hong Kong branch of the Defendant and suffered loss as a result. The Plaintiff initiated a claim in tort against the Defendant in the Chinese court (despite the Jurisdiction Clause), alleging that the Defendant had engaged in fraudulent sale, wrongful disposition and conversion of his property.

The Defendant invoked the foreign Jurisdiction Clause and challenged the jurisdiction of the Shanghai No. 1 Intermediate People's Court. The court agreed with the Defendant.

The Plaintiff subsequently appealed to the Shanghai High People's Court and the Supreme People's Court. Both attempts were dismissed by the courts.

**Issues And Decisions**

- *Did the Jurisdiction Clause apply to tortious claims?*

  The Plaintiff argued that Chinese courts should have jurisdiction because his claim arose from the tortious acts of the foreign bank in its selling activity, rather than from a breach of contract. Since the Defendant’s assets were located in China, the Plaintiff was entitled to bring a claim against the Defendant in the Chinese courts.
The trial court held that the Jurisdiction Clause was valid to confer on the Hong Kong courts’ exclusive jurisdiction over the Plaintiff’s claim. Regardless of whether the claim was based in contract or in tort, it would necessarily involve the adjudication of the effect and performance of the Mini-master Agreement which, in accordance with the foreign jurisdiction clause, was a matter for the Hong Kong courts to decide. This decision was upheld by the courts on appeal.

• Is there a conflict between the Jurisdiction Clause under the Mini-master Agreement and non-exclusive jurisdiction clauses under other finance documents?

The Plaintiff alleged that, in light of the non-exclusive jurisdiction clause under the Charge over Cash Deposit and Securities (Charge), the Chinese court should also have jurisdiction over disputes relating to the KODA contracts.

The trial court disagreed on the basis that the facts upon which the Plaintiff based its case only related to the Mini-master Agreement (i.e. the Charge was irrelevant). In addition, the Charge is a mere sub-contract to the Mini-master Agreement such that applying the general rules of contract law, the Jurisdiction Clause (which is in the main agreement) should prevail over the clause in the Charge.

• Is the Jurisdiction Clause valid under English law?

The Plaintiff argued that the Jurisdiction Clause is invalid under English law so that the Chinese courts should have jurisdiction over the dispute.

The court rejected this argument on the basis that the determination on jurisdiction clauses is a procedural issue rather than a substantial matter and according to the international private law rules of China, the validity of the jurisdiction of the court selected by the parties (here, Hong Kong courts) should be determined by Hong Kong law (and not English law despite it being the governing law).
Li Shoujia

Li Shoujia v Bank of China Limited Beijing Shangdi Xinxi Road Sub-branch

(1) Trial: 李寿佳与中国银行股份有限公司北京上地信息路支行期货欺诈责任纠纷一审判决书【北京市海淀区人民法院，（2011）海民初字第12709号】
(2) Appeal & final: 李寿佳与中国银行股份有限公司北京上地信息路支行期货欺诈责任纠纷上诉案【北京市第一中级人民法院，（2011）一中民终字第10830号】

Facts

In February 2010, Mr Li Shoujia (Plaintiff) purchased two gold options from Bank of China Limited Beijing Shangdi Xinxi Road Sub-branch (Defendant), but suffered losses in both transactions.

The Plaintiff then brought the claim before the trial court, requesting the Defendant to compensate for the loss (premium) the Plaintiff suffered. The Plaintiff challenged the fairness in the Defendant's gold options business. According to the Plaintiff, the gold options business was a disguised form of fraud. As such, the transaction and the business relationship between the parties should be invalid.

Furthermore, the Defendant was alleged to have failed to conduct the risk assessment on the Plaintiff, as well as disclose the transaction risks and obtain the requisite representations or confirmation from the Plaintiff before entering into the transaction. Accordingly, the Plaintiff alleged that the transaction was conducted with no transparency or fairness, and his interests were harmed.

Issues And Decisions

The Beijing No. 1 Intermediate People's Court held that the dispute related to a financial derivative.

The court further held that the Plaintiff being an individual with full civil conduct capacity should have a clear understanding of the risks associated with the gold options business.

In addition, other than the two gold options in dispute, the Plaintiff had previously benefited over 1,100 renminbi from another gold option contract, which clearly indicated the Plaintiff's experience in trading gold options.

Finally, the court had reason to doubt whether the Plaintiff's claim was made in good faith, and thus refused to accept the Plaintiff's allegation that the Defendant's gold options business lacked transparency and fairness.
Liugong

Citibank (China) Co., Ltd., Guangzhou Branch v Guangxi Liugong Machinery Co., Ltd.

(1) Trial: 花旗银行(中国)有限公司广州分行与广西柳工机械股份有限公司金融衍生品种交易纠纷一审民事判决书【广东省广州市第一中级人民法院,(2012)穗中法民四初字第13号】
(2) Final: 广西柳工机械股份有限公司与花旗银行(中国)有限公司广州分行金融衍生品种交易纠纷二审民事判决书【广东省高级人民法院,(2014)粤高法民二终字第60号】

Facts

Guangxi Liugong Machinery Co., Ltd. (Defendant) is a state-owned large-scale enterprise engaged in construction machinery manufacturing. In 2011, as part of its plan to expand its global market, the Defendant proposed to acquire a Polish manufacturer Huta Stalowa Wola (Acquisition Project).

The purchase amount under the Acquisition Project was the Polish złote equivalent of $35 million. In order to hedge the currency risk, the Defendant entered into a series of foreign exchange spot and forward transactions with Citibank (China) Co., Ltd., Guangzhou Branch (Plaintiff). Details of the transactions were:

<table>
<thead>
<tr>
<th>Trade</th>
<th>Trade dates</th>
<th>Description of the trade</th>
<th>Settlement dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade 1</td>
<td>April 29, 2011 (further extended to July 29, 2011)</td>
<td>The Plaintiff was scheduled to sell an amount of Polish złote 138.5 million on the settlement date against a payment of $52,258,348.96 (@2.6507) to be paid by Defendant on the same settlement date</td>
<td>October 27, 2011 (extended from July 29, 2011)</td>
</tr>
<tr>
<td>Trade 2</td>
<td>October 21, 2011</td>
<td>At the request of the Defendant, the Plaintiff was scheduled to buy Polish złote 138.5 million from the Defendant on October 27, 2011 at $43,281,250 (@3.2000) to unwind the first trade.</td>
<td>October 27, 2011</td>
</tr>
</tbody>
</table>

The parties signed the relevant facility agreement, the risk disclosure statements, the trade authorisation, the FX purchase and sales letter and the FX trade confirmation.

The Plaintiff netted off Trade 1 and Trade 2 on the same settlement date (October 27, 2011) and claimed for the difference. The Defendant failed to pay.

The Plaintiff brought a claim for the amount owed by the Defendant before the Guangzhou Intermediate People's Court which ruled in the Plaintiff’s favour. The Defendant appealed to the Guangdong High People's Court (which dismissed the appeal).

Issues And Decisions

- **Whether the parties should sign a separate derivative contract?**

  The Defendant claimed the transaction was invalid because the parties should have entered into a separate standard derivative contract. Without a standard document, the Defendant was misled and therefore, had an incorrect understanding of the nature of the transaction and the risks associated with the transaction.
The trial court noted the Defendant failed to prove that the use of separate standard documents was a mandatory requirement under Chinese law, and held that the transaction was valid notwithstanding the lack of a separate standard derivative contract.

- **Is the derivative agreement valid?**
  - **Parties’ capacity to enter into the derivative contract**

  The court examined the reply issued by the CBRC and the filing receipt issued by the CBRC Guangdong Bureau obtained by the Plaintiff, and held that the Plaintiff had the capacity to enter into FX-FX forward transactions.

  The Defendant, being a state-owned enterprise, argued that it can only enter into derivatives that are in compliance with the hedging accounting policies pursuant to the SASAC Notices. The Defendant further argued that since the trades in dispute did not fall under the category of ‘hedging derivatives’ and the trades had not been approved by the Guangxi State-assets Administration Commission, the Defendant did not have the requisite capacity to enter into the derivative trades in question. In any event, the Defendant argued that the trades had not been expressly approved by the board or shareholders of the Defendant.

  The court rejected the Defendant’s argument and held that the Defendant had the requisite capacity to enter into the derivative trades on the basis that (i) the SASAC Notices only applied to SOEs at the central level while the Defendant was a provincial SOE, and (ii) the signatories of the derivative documents had all been duly authorized by the board of directors of the Defendant and, in any event, the lack of board approval in relation to the entry of derivative transactions was an internal corporate governance matter and should not affect the validity and effectiveness of the derivative agreement between the parties.

  - **Are there any breaches that would adversely affect the validity of the derivative agreement?**

    The Defendant argued that the Plaintiff had failed to fully disclose the nature of, and the risks associated with, the trades, and the Defendant had understood the Plaintiff was its agent and the advisor.

    However, the court found that the Plaintiff had provided the relevant materials including the introduction to the derivatives, risk disclosure statements and case scenario analysis to the Defendant, and the Defendant should have known the role of the Plaintiff and the risks associated with the transactions. As such, the court was satisfied that the Plaintiff had complied with the regulatory requirements under the Derivative Transactions Interim Measures.

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111 The court ruled that only breaches of (i) laws published by the National People’s Congress and its standing committee and (ii) administrative regulations published by the State Council could invalidate a derivative contract. Given the Derivative Transactions Interim Measures were neither laws nor administrative regulations, even in the case of any breach thereof, the validity and effectiveness of the derivative agreement was unaffected.
• Has the derivative agreement been performed?

The Defendant alleged that (i) the parties were only in an early stage of negotiating the transactions, and the derivative agreement had not been concluded, and (ii) in any event, it had not performed its obligation to pay the US dollar amount to the Plaintiff in exchange for Polish złote in Trade 1, the transactions had never been performed and so there should be no losses suffered by the Plaintiff.

The trial court rejected the argument on the basis that, prior to the original settlement date for Trade 1, the Defendant requested several extensions and after the Plaintiff offered two options to the Defendant (one being to settle Trade 1 by gross payments, and the other being to unwind Trade 1 by entering into a second trade, where only a single amount in US dollar netted from the two trades would be paid), the Defendant accepted the second option. The court held that this demonstrated performance of the agreement.

• Did the parties have the intention to net off the trades?

The Defendant argued that the parties had not agreed to net off the trades, but agreed to settle in gross the payments in US dollar and Polish złote.

The courts recognized payment netting under the mini-master agreement and held that payment netting is a common settlement method to reduce settlement risk. In coming to the conclusion, the courts held that the transaction records and trade confirmations signed by the Defendant indicated its agreement to payment netting. The Defendant was found to have also mentioned ‘payment netting’ in correspondence after the second transaction was entered into, which again demonstrated that the parties reached an agreement on payment netting.

• Should the termination amount and interest be upheld?

Based on the decision that payment netting is a common settlement mechanism, the court upheld the calculation of the termination amount made by the Plaintiff.
Liu Li

Liu Li v Tao Li, Tong Wu

申请人刘利与被申请人陶莉、童武申请承认和执行外国法院民事判决一案民事裁定书【湖北省武汉市中级人民法院，（2015）鄂武汉中民商外初字第00026号】

Facts

Liu Li (Plaintiff) brought an action against Tao Li and Tong Wu (Defendants) pursuant to a share transfer agreement in respect of the shares of a California company. The Plaintiff brought proceedings before the Los Angeles Superior Court in California claiming a fabricated share transfer.

On July 24, 2015, the US court issued a default judgment against the Defendant ordering it to return the share purchase price (plus other amounts) to the Plaintiff.

On October 19, 2015, the Plaintiff applied to the Wuhan Intermediate People's Court to enforce the US judgment against the Defendants as they lived in Wuhan and owned assets located in Wuhan.

Issues And Decisions

• Should the US judgment be recognized and enforced in China?

The Plaintiff argued that there was reciprocity between China and US, citing an earlier case where a Chinese judgment issued by the Hubei High People's Court was recognized and enforced by the District Court of the Central District of California.

The Wuhan court held that de facto reciprocity had been established and hence the US judgment should be recognized and enforced on that basis.

• Should the Chinese court examine the merits of the case when recognising and enforcing the US judgment?

No. The Wuhan court held that in recognition and enforcement proceedings, the Chinese court should not consider the merits of the foreign judgment.

The Chinese court was therefore not required to consider the Defendant's arguments as to the non-binding effect of the US judgment in China or the validity of the share transfer agreement.
On Hing Paper

On Hing Paper Company Limited, Lam Fung Yam and others v Fubon Bank (Hong Kong) Limited

(1) Trial: 安兴纸业有限公司、林凤鑫与富邦银行（香港）有限公司、姚国安金融衍生品种交易纠纷【广东省深圳前海合作区人民法院, (2016) 粵0391民初539号之一】

(2) Final: 安兴纸业有限公司、林凤鑫与富邦银行（香港）有限公司金融衍生品种交易纠纷二审民事裁定书【广东省深圳市中级人民法院, (2016) 粵03民辖终2422号】

Facts

A dispute arose from a derivative agreement between Fubon Bank (Hong Kong) Limited (Plaintiff) and On Hing Paper Company (Defendant). The Plaintiff commenced action in Shenzhen Qianhai Cooperation Zone People’s Court, but the Defendant challenged the jurisdiction of the Qianhai court on the basis that the court was an inconvenient forum having no jurisdiction over the dispute.

The challenge was declined by the Qianhai court and the Defendant appealed to the Shenzhen Intermediate People’s Court. The appeal was rejected.

Issues And Decisions

• The application of forum non conveniens

  The Defendant argued that (i) none of the parties were domiciled in China and the dispute was not relevant to the interests of the state, citizens, corporations or other organisations of China; and (ii) the Qianhai court had material difficulty in applying Hong Kong law when hearing the case.

  The courts held that:

  • A Chinese court must be satisfied that each of the six conditions is met under Article 532 of the Civil Procedures Law Interpretation before it declines jurisdiction;

  • The fourth condition that ‘the case is not related to the interests of the state, citizens, corporations or other organisations of China’ was not satisfied on the basis that the Defendant had property in Shenzhen (ie, the shares it held in a Chinese company) and the dispute was related to that Chinese company; and

  • With respect to the fifth condition ‘the Chinese courts may have material difficulty in deciding the facts or applying the relevant law when hearing the case’, the Shenzhen court had no material difficulty in finding and applying Hong Kong law when hearing the case.

In other words, not each and every condition for the Chinese court to decline jurisdiction as set out in Article 532 of the Civil Procedures Law Interpretation was satisfied. Therefore, the challenge of the jurisdiction of Chinese courts was declined.
Facts

In July 2009, Shandong Century Sunshine Paper Group Co., Ltd. (Defendant) entered into an NAFMII Master Agreement with Deutsche Bank (China) Limited, Shanghai Branch (Plaintiff) and entered into a US dollar-denominated swap linked to the performance of US dollar LIBOR and euro EURIBOR.

The Defendant failed to make a payment under the swap. The Plaintiff early terminated the trade and claimed the early termination amount. The Defendant refused to pay and the Plaintiff submitted the dispute to CIETAC Shanghai sub-commission in accordance with the arbitration clause in the NAFMII Agreement.

CIETAC issued its arbitral award in favour of the Plaintiff and upheld, inter alia, the early termination amount claimed by the Plaintiff. The Plaintiff then filed a request to the Shandong Weifang Intermediate People's Court for enforcement of the award.

The Defendant argued that (i) the Plaintiff had concealed evidence that was key for CIETAC Shanghai sub-commission to grant a fair arbitral award and (ii) the evidence relied upon in the grant of the CIETAC award was forged.

The Intermediate Court accepted the Defendant's first argument and refused to enforce the award. The Plaintiff then requested the Shandong High People's Court to review the case. The High Court ordered the Intermediate Court to re-hear the case. However, the Intermediate Court came to the same conclusion and refused to enforce the arbitral award.

Issues And Decisions

In the retrial, the Intermediate Court once again refused to enforce the award and held that the Plaintiff did conceal evidence that impaired the tribunal's ability to issue a fair arbitral award. In particular, the Plaintiff failed to disclose that its parent company was reportedly involved in the manipulation of LIBOR and EURIBOR. Such information was not disclosed by the Plaintiff to the arbitration institution when the case was originally heard, and if it had been disclosed to CIETAC Shanghai sub-commission, the arbitration institution should have taken a more prudent and careful assessment of the dispute.

During the arbitral proceedings, the so-called fair market value quotations provided by the Plaintiff to CIETAC during the arbitral proceedings were sourced from offshore locations and could have been obtained from other foreign banks that were also under investigation by the foreign regulators for manipulation of LIBOR/EURIBOR.
Westlands

Westlands Machinery (Zhuhai) Co., Ltd. v China Construction Bank, Zhuhai Branch

(1) Trial: 汇能特机械（珠海）有限公司与中国建设银行股份有限公司珠海市分行金融衍生品种交易纠纷一审民事判决书【广东省珠海市香洲区人民法院，（2016）粤0402民初1138号】
(2) Final: 汇能特机械（珠海）有限公司与中国建设银行股份有限公司珠海市分行金融衍生品种交易纠纷二审民事判决书【广东省珠海市中级人民法院，（2016）粤04民终1932号】

Facts

In April 2011, Westlands Machinery (Zhuhai) Co., Ltd. (Plaintiff) and China Construction Bank, Zhuhai Branch (Defendant) entered into an FX/renminbi Forward Trade General Agreement (General Agreement). In September 2011, the parties entered into a deliverable US dollar/renminbi forward trade with a notional amount of $9,000,000.

From September 6, 2012 (being the original termination date) to October 20, 2014 (being the final termination date), the Plaintiff failed to pay the US dollar amount to the Defendant on the settlement date that was extended several times (but only ever settled part of the trade). The notional amount of the trade was reduced to $6,525,000.

The Defendant refused to further extend the trade because of the Plaintiff's default and served a default confirmation with a final settlement amount of approximately 0.87 million renminbi payable to the Plaintiff. The Plaintiff disagreed, claiming approximately 1.80 million renminbi.

The Plaintiff sued the Defendant and the trial judgment was issued in favour of the Defendant. The Plaintiff appealed but the trial judgment was affirmed.

Issues And Decisions

• Nature of the dispute: a dispute over the agreement of agency or the derivative agreement

The Plaintiff alleged that the General Agreement should be construed as an agency agreement whereby the Defendant was acting as the agent of the Plaintiff to conduct US dollar/FX forward business.

The Plaintiff also argued that the relationship between itself and the Defendant under the General Agreement was comparable to the broker-client relationship, such that all losses should be assumed by, and all gains should be attributed to, the client, rather than the agent bank.

Both the trial court and the court of appeal rejected the Plaintiff’s argument and the court of appeal ruled that the nature of a document should be determined by the relationship between the parties rather than the words used in the document. As such, although the FX/renminbi Application Form relating to the trade contained words such as ‘entrustment’ or ‘agency’, the transactions were entered into on a principal-to-principal basis and the General Agreement and other documents constituted a derivative contract.
• *Should the Plaintiff’s claims be upheld?*

The Plaintiff argued that it was entitled to a settlement amount of approximately 1.80 million renminbi calculated based on the difference between the forward rate and the prevailing rate on the settlement date.

However, the Defendant argued that pursuant to the General Agreement, failure by the Plaintiff to ensure sufficient funds were available in the agreed account for settlement constituted an automatic waiver of exercise of the Plaintiff’s rights. Given that the Plaintiff did not have sufficient US dollar fund in the account, its rights to exercise had been waived.

The court upheld the Defendant’s argument.

The court rejected the Plaintiff’s claims on the basis that:

• Firstly, it was the Plaintiff that defaulted under the trade. It should therefore be the Plaintiff that bears the loss arising from the default. There was no law or regulation to support the Plaintiff’s claims.

• Secondly, the parties only agreed that the Plaintiff should be exposed to gains/losses arising from the extensions of the trade. The General Agreement did not provide for any profit sharing mechanism in relation to a forced unwinding process, nor did the parties reach agreement of unwinding gains/losses on the disposal.

• Lastly, there was no custom established in the market or between the parties that all losses/gains should be borne or enjoyed solely by the Defendant.
Xu Zhiming

Xu Zhiming v Zhang Yihua

(1) Trial: 徐志明与张义华股权转让合同纠纷一审民事裁定书【武汉市中级人民法院，（案号不详）】
(2) Appeal: 徐志明与张义华股权转让合同纠纷二审民事裁定书【湖北高院，（2014）鄂民四终字第00188号】
(3) Retrial: 徐志明与张义华股权转让纠纷申请再审民事裁定书【最高人民法院，（2015）民申字第471号】

Facts

Xu Zhiming (Plaintiff) entered into a Share Transfer Agreement (STA) with Zhang Yihua (Defendant) in relation to its 100% shares in Rich Fortune Limited (a Mongolian industrial company). The STA provided that the STA was governed by Mongolian law and that all disputes were to be submitted to the Mongolian courts. The parties agreed that each party may apply for freezing orders in respect of properties owned by Rich Fortune Limited located in Mongolia.

The Plaintiff brought proceedings in the Wuhan Intermediate People's Court and Hubei High People's Court but both courts dismissed his claims. The Defendant applied to the SPC for a retrial.

Issues and decision

The key issue was the validity of the jurisdiction provisions of the STA and the related exclusivity issues. Since jurisdiction provisions were procedural issues, the laws of the applicable court (ie, Chinese law) should apply.

- Validity of governing law clause

The Plaintiff submitted that the jurisdiction provision in the STA was unclear and non-specific, and therefore did not comply with Article 34 of the Chinese Civil Procedures Law. The SPC held that both parties' choice of Mongolian law complied with Article 34. The court further held that although the parties did not specifically agree which Mongolian court a dispute should be submitted to, this was an issue to be determined pursuant to Mongolian law.

The Plaintiff argued the purpose of the jurisdiction clause in the STA was to seize the properties of Rich Fortune Limited and was therefore detrimental to the interest of the company, its employees and related third parties (such as creditors) in Mongolia. As such, according to the governing law of the contract (ie, Mongolian law), the jurisdiction clause should be invalid.

The court held that whether the jurisdiction clause harmed the interests of third parties was a question to be determined by the Mongolian courts and should not affect the parties' agreement on foreign jurisdictions.
• **Exclusivity**

The Plaintiff submitted that the jurisdiction clause was read exclusive because the clause only provided that the parties may bring a claim in the Mongolian courts in the event of breach, such that the Chinese courts also have jurisdiction over the dispute.

The SPC held that the expression ‘may’ in the jurisdiction clause simply reflected the fact that the parties had a right but not an obligation to bring proceedings before the Mongolian courts but did not mean the parties agreed to submit their disputes to other courts. In addition, the STA did not contain any provision to indicate that the parties had only agreed to submit to the non-exclusive jurisdiction of the Mongolian courts.

The SPC held that Mongolia had the most convenient process for the freezing of the company’s assets. Therefore, the parties’ agreement that the parties had the right to seize the property owned by Rich Fortune Limited that was located in Mongolia was sufficient to persuade the court that the parties had a genuine intention to submit to the exclusive jurisdiction of the Mongolian courts.

The SPC therefore dismissed the Plaintiff’s claim.
Yingda

Citibank (China) Co., Ltd. v Yingda Life Electric (Zhongshan) Co., Ltd.

花旗银行(中国)有限公司诉樱达生活电器(中山)有限公司等金融衍生品种交易纠纷案【上海市浦东新区人民法院，（2014）浦民六（商）初字第S3800号】

Facts

In June 2012, Citibank (China) Co., Ltd. (Plaintiff) and Yingda Life Electric (Zhongshan) Co., Ltd. (Defendant) entered into a Derivative General Agreement and the Supplement thereto. The Plaintiff and Defendant entered into a US dollar/renminbi forward trade under which the parties agreed to exchange US dollar and renminbi amounts on five different settlement dates.

The Defendant defaulted in March 2014 (before the occurrence of any scheduled settlement date). The Plaintiff therefore calculated and determined the close-out amount and served the early termination notice.

The Defendant failed to settle the early termination amount and the Plaintiff brought a claim before the Shanghai Pudong New Area People's Court. The Defendant did not respond and a default judgment was issued in favour of the Plaintiff.

Issues And Decisions

• The calculation of the early termination amount

For the purpose of calculating the early termination amount, the court considered that the process should be carried out in good faith and a commercially reasonable manner. The parties should not only abide by the provisions relating to default under the Chinese Contract Law but also take into account the relevant customs in the derivative-related market.

The Plaintiff’s calculation of the early termination amount was based on the amount of losses or costs it would incur or gains it could realise in replacing or in providing the economic equivalent of the material terms of the terminated trade.

This ‘close-out amount’/replacement transaction calculation method was upheld by the court.

112 In Chinese phrase, ‘替代交易法’, which should be substantially similar to the close-out amount calculation under the ISDA agreement
Zhajiasu Highway

Jiaxing Zhajiasu Highway Co., Ltd. v Industrial and Commercial Bank of China, the Shanghai Bund Sub-branch

(1) Trial: 嘉兴市乍嘉苏高速公路有限责任公司与中国工商银行股份有限公司上海市外滩支行金融衍生品交易纠纷一审民事判决书【上海市第一中级人民法院，（2011）沪二中民六（商）初字第15号】
(2) Final: 嘉兴市乍嘉苏高速公路有限责任公司与中国工商银行股份有限公司上海市外滩支行金融衍生品交易纠纷二审民事判决书【上海市高级人民法院，（2013）沪高民五（商）终字第5号】

Facts

On June 19, 2007, Jiaxing Zhajiasu Highway Co., Ltd. (Plaintiff) and Industrial and Commercial Bank of China, the Shanghai Bund Sub-branch (Defendant) entered into a General Agreement for Client Wealth Management and Risk Management Business (General Agreement).

On June 21, 2007, the Plaintiff also signed an instruction (in the form of power of attorney) to engage the Industrial and Commercial Bank of China, Shanghai Branch (ICBC Shanghai Branch) to conduct a 13.5 years renminbi interest rate swap referencing the performance of the EUR CMS30-CMS2.

On August 29, 2007, ICBC Shanghai Branch delivered the trade confirmation to the Plaintiff.

Between May and June 2008, the Plaintiff delivered an unwinding instruction and restructuring instructions to ICBC Shanghai Branch. However, no unwinding was made because the parties disagreed on the unwinding conditions.

On July 10, 2008, the Defendant notified the Plaintiff that it has incurred a substantial loss as a result of the renminbi interest rate swap.

In September 2008, the Plaintiff requested revocation of the General Agreement, but was rejected by the Defendant.

On May 21, 2009, the Plaintiff served a letter on the Defendant undertaking to deliver the unwinding instruction by December 20, 2009 and assume all losses thereunder. From June to August 2009, the Plaintiff delivered several unwinding instructions and the Defendant sent two unwinding notices to the Plaintiff confirming the completion of the unwinding activities and a total loss of more than 55.84 million renminbi.

The Plaintiff commenced action in the Shanghai No. 1 Intermediate People’s Court in 2010-2011 and claimed for a loss of approximately 49.5 million renminbi comprising of 7.15 million renminbi in performing the trade and 42.35 million renminbi in unwinding the trade. The trial judge ordered 6.35 million renminbi (being 15% of the unwinding loss) be paid by the Defendant. Both parties appealed.

The Shanghai High People’s Court heard the appeal in 2013 and upheld the judgment of the trial court.
Issues And Decisions

• Nature and validity of the General Agreement and other transaction documents

  ◦ Is the contract in question a client wealth management entrustment agreement or a derivative contract?

  The court of appeal held that the General Agreement was, in substance, a derivative contract on the basis that the transactions involved mutual payment arrangements (rather than a one-way entrustment relationship where the Plaintiff entrusted the Defendant to manage its properties or business).

  ◦ Validity of the derivative contract and the capacity of the Defendant

  The court upheld the validity of the derivative documents as it did not find any violation of the provisions relating to voidable contracts (for example, violation of the public interests) under the Chinese Contract Law.

  The court held that the Defendant had the requisite capacity to enter into the contract. Although the Defendant had allegedly only finished the CBRC filing procedures as required by the Derivative Transactions Interim Measures after the entry of the derivative documents, the court ruled that the Plaintiff has the capacity because:

  – The Defendant’s breach of the CBRC rules may not necessarily invalidate a contract as the CBRC rules are not mandatory Chinese law. The breach will only result in regulatory action against the party in breach,

  – Had the Plaintiff had any doubt in relation to the Defendant’s licensing status, it should not have entered into the transaction or should have at least raised this issue with the Defendant. The Plaintiff’s failure to raise any concern represents its deemed ratification of the Defendant’s capacity.

• Whether the Defendant had fulfilled its obligations such as information and risk disclosure

  Although the court upheld the validity of the General Agreement and other transaction documents despite the fact that it failed to meet the standards of international derivative documentation, it nevertheless pointed out that the Defendant, as a professional bank, failed to fully disclose all relevant risks, including the market risk, credit risk, liquidity risk and legal risk.

  ◦ Risk disclosure obligations relating to the unwinding measures

  At the time of entering into the derivative contract, the Defendant did not provide sufficient information about the unwinding or termination methods, procedures and consequences. The Plaintiff chose to unwind the trade after the Defendant disclosed information about the unwinding measures to the Plaintiff. The Plaintiff therefore chose to unwind the trade on an informed basis. The court apportioned the liability for the loss incurred during the course of unwinding the trade as 85% (Plaintiff) and 15% (Defendant).

  ◦ Risk disclosure obligations during the term of the trade

  The Defendant had sufficiently fulfilled and discharged its risk disclosure obligations to the Plaintiff and so, the court rejected the Plaintiff’s claim for 7.15 renminbi (being the loss it incurred from performance of the trade).
Zhang Zhuqing

Zhang Zhuqing v Ping An Bank Co., Ltd., Qingdao Nanjing Road Sub-branch

(1) Trial: 张竹青、平安银行股份有限公司青岛南京路支行侵权责任纠纷一审民事判决书【青岛市市南区人民法院，（2014）南民重字第20003号】

(2) Appeal & Final: 张竹青、平安银行股份有限公司青岛南京路支行侵权责任纠纷二审民事判决书【青岛市中级人民法院，（2016）鲁02民终2169号】

Facts

In November 2011, Ping An Bank Co., Ltd. Qingdao Nanjing Road Sub-branch (Defendant) promoted the gold products with deferred settlement terms (T+D gold products) to Zhang Zhuqing (Plaintiff). The Defendant opened a precious metal trading account for the Plaintiff. The Plaintiff was asked to sign on the same day a Wealth Management Agreement with Heng Zi Jin Co., Limited (Heng Zi Jin), pursuant to which the Plaintiff entrusted Heng Zi Jin to invest his money into the T+D gold products, and the Plaintiff agreed to share the profits and the risks with Heng Zi Jin.

The Plaintiff claimed for return of investment principal for the T+D gold products and the accrued interest, but was rejected by the trial court.

The Plaintiff appealed to the Qingdao Intermediate People's Court and the trial judgment was reversed.

Issues And Decisions

According to the trial court, the Defendant merely provided a trading platform for the Plaintiff to trade T+D gold products and there was no wealth management contract relationship between the parties. The Plaintiff failed to provide evidence to prove that the Defendant's tortious acts, nor could the Plaintiff establish the causation of the tort. Therefore, the case was rejected.

In the appeal proceedings, the court of appeal held that the issues in dispute were:

• Relationship between the Defendant and the Plaintiff

In light of the fact that the T+D gold products were proactively promoted by the Defendant to the Plaintiff, and the Plaintiff's precious metal trading account was opened with the Defendant in its office, the Plaintiff and the Defendant had created a legal relationship in relation to the wealth management advisory service. Accordingly, the Defendant's promoting and advising activities constituted 'investment or wealth management advisory services'.

• Tort acts of the Defendant

The court further held that, in a wealth management advisory business, the Defendant (i) highly recommended the T+D gold products to the Plaintiff even though the T+D gold products were high-risk and that other clients who had invested in the products had suffered substantial losses, (ii) failed to assess the risk tolerance level of the Plaintiff and (iii) failed to fully disclose the risk associated with the T+D gold products.
As a result of (i), (ii) and (iii), the court held that the Defendant not only breached its duty to conduct risk assessment, risk disclosure and make suitable recommendations, there was also an element of ‘subjective intention’ in its behaviour and the causation as a result of which the Plaintiff suffered loss from its investment in the product.

The court therefore ordered the Defendant to compensate the Plaintiff for his loss in the amount of 500,000 renminbi.
Facts

The case involved the Shanghai Branch of Standard Chartered Bank (China) Co., Ltd. (Plaintiff), Zhongmei Technology (Shanghai) Co., Ltd. (Defendant) and its parent company called Taiwan Waffer Technology Corporation (Waffer Company).

Key findings of the facts were:

- The Plaintiff and the Defendant had entered into certain documents since 2007, including a Standard Client Agreement, US dollar/renminbi Bank Facility Letter, Foreign Exchange Business Terms and Conditions and Transaction Authorisation;

- In January 2008, two of Waffer Company’s employees (Mr Li Zengxing and Mr Lin Rongzhao) discussed the Plaintiff’s structured forward transactions business over the phone in the name of the Defendant;

- On January 11, 2008, the General Manager of the Defendant in China (Mr Li Tianyao) signed a document titled ‘LIBOR-linked Forward Foreign Exchange’, which document included (i) risk warnings and (ii) a pre-trade confirmation. Mr Li Zengxing and Mr Lin Rongzhao of Waffer Company, who continued to negotiate the trade terms with the Plaintiff on behalf of the Defendant, confirmed by telephone the trade terms in the pre-trade confirmation and gave trading instructions;

- On February 15, 2008, being the first settlement date, the Defendant refused to pay the US dollar amount to the Plaintiff as agreed; and

- In March 2008, the Plaintiff issued a termination notice in relation to the “LIBOR-linked Forward Foreign Exchange” transaction, and claimed against the Defendant for loss suffered by the Plaintiff as a result of the Defendant’s failure to fulfil its obligations under the FX transaction.

Issues And Decisions

Decision Of The Trial Court

The Shanghai Minhang People’s Court held that the Plaintiff failed to provide sufficient evidence to demonstrate that:

- It had entered into a valid written contract with the Defendant in respect of the business/transaction;
• The employees of Waffer Company who communicated with the Plaintiff over the phone in relation to the FX transaction had 'apparent authority' to do so on behalf of the Defendant; or
• The parties reached any valid oral contract or agreement for the disputed structured forward transactions.

The losses incurred by the Plaintiff were caused by its own decision to undertake the transaction when there were no clear contractual relationships between the Plaintiff and the Defendant. The Plaintiff was therefore solely responsible for its losses.

**Decision Of The Court Of Appeal**

Upon appeal to the Shanghai No.1 Intermediate People's Court by the Plaintiff, the court held that:

• The dispute arose from financial derivative trading;

• In the absence of laws or regulations over such types of products and transactions, the formation and validity of such trades should be determined using market practice and the relevant regulations published by the relevant industry authorities. Pursuant to ISDA’s requirements, parties entering into derivative transactions should sign an ISDA Master Agreement (which includes the Master Agreement, Schedule and Confirmations).

• In this case:
  • The ‘Foreign Exchange Business Terms and Conditions’ (FX Terms) provided by the Plaintiff clearly stated that its purpose is to constitute a master agreement. However, the terms of the FX Terms were substantially different to the terms of the ISDA Master Agreement. It did not contemplate any Confirmation nor did it contain trade terms (such as underlying or price). The FX Terms did not satisfy the ‘single agreement’ requirement generally applicable to master agreements for financial derivative transactions, nor did they represent a mutual agreement between the Plaintiff and the Defendant in relation to the derivative transaction in question; and

  • Mr Li Tianyao, as the general manager of the Defendant, only signed a document named ‘LIBOR-linked Forward Foreign Exchange’ that included a pre-trade confirmation. The document was for discussion purposes and did not form part of the derivative contract that bound the Defendant.

The Plaintiff alleged that it followed the market practice and custom, but failed to provide any evidence. Furthermore, negotiation by way of email or phone calls were regarded as not having binding effect. In addition, despite a signed Power of Attorney, the absence of any authorized person appointed thereunder indicated there was no effective authorisation.

• Although the negotiation process was conducted between the employees of the Plaintiff and Waffer Company, the documentation was prepared by the Plaintiff based on the negotiation between the parties. Further facts as follows were established:
  • The Plaintiff was clearly aware that the authorized persons section in the Defendant’s Power of Attorney was blank;

  • The Plaintiff actually knew that the two employees communicated with the Plaintiff during the trade discussions process were not employees of the Defendant;
All transaction documentation for the FX transaction was prepared based on the Plaintiff’s standard fixed forms and the Plaintiff should have known the flaws with the trade documentation and the lack of specific corporate authority on the part of the representatives of the counterparty; and

The Plaintiff had not taken any ratification measures to fix the issues with the trade authority documentation.

In light of these facts, no ‘apparent authority’ could be established. Accordingly, the acts and instructions of Waffer Company did not bind the Defendant, and the derivative trade was not concluded.

- The Plaintiff negligently entered into the derivative trade without obtaining due authorisation of its counterparty and should therefore bear the loss arising from the contract.

- However, as the parties had reached a preliminary agreement during the initial stages of the trade that resulted in the Plaintiff’s reasonable reliance to act on the preliminary agreement, such activities should fall within Article 42(3) of the Chinese Contract Law (which provides that a party is liable for damages if it violates the principle of good faith in concluding a contract).

The court therefore held that each party should bear corresponding responsibilities on a 50%-to-50% basis.

**Decision Of The Retrial Court**

The Shanghai People’s Procuratorate filed a retrial request with the Shanghai High People’s Court on the basis that the Defendant should not be held liable for any pre-contract fault. The Shanghai High People’s Court agreed with, and upheld, the decision of the court of appeal that (i) the contract had not been concluded, and (ii) parties should not be held responsible for any loss arising from a concluded contract, instead, they should bear the loss incurred in concluding the contract.
## GLOSSARY

<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
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<tbody>
<tr>
<td>Belt and Road</td>
<td>An initiative announced in October 2013 by President Xi Jinping of the China to promote economic cooperation and partnership through the building of a transaction and infrastructure network connecting China, Central Asia, the Middle East, Africa, Europe and Russia</td>
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<td>CBRC</td>
<td>China Banking and Insurance Regulatory Commission (or formerly China Banking Regulatory Commission)</td>
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<td>CIETAC</td>
<td>China International Economic and Trade Arbitration Commission</td>
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<td>Hague Convention</td>
<td>The Hague Convention of June 30, 2005 on Choice of Court Agreements</td>
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<td>ISDA</td>
<td>International Swaps and Derivatives Association, Inc.</td>
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<tr>
<td>ISDA Master Agreements</td>
<td>Agreements based on standard form documents published by ISDA for privately negotiated derivative transactions entitled ‘1992 ISDA Master Agreement’ and the ‘2002 ISDA Master Agreement’</td>
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<tr>
<td>ISDA memorandum on China close-out netting</td>
<td>Legal memorandum on the enforceability of close-out netting of privately negotiated derivative transactions under ISDA Master Agreements in China, issued by King &amp; Wood Mallesons on March 16, 2017 and published by ISDA</td>
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<td>NAFMII</td>
<td>National Association of Financial Market Institutional Investors</td>
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<td>NDRC</td>
<td>National Development and Reform Commission of China</td>
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<td>New York Convention</td>
<td>The Convention on the Recognition and Enforcement of Foreign Arbitral Awards</td>
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<td>OTC</td>
<td>Over-the-counter</td>
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<td>SAC</td>
<td>Securities Association of China</td>
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<td>SAFE</td>
<td>State Administration of Foreign Exchange</td>
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<td>SOE</td>
<td>Chinese state-owned enterprise</td>
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<td>SPC</td>
<td>Supreme People’s Court</td>
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<td>State Council</td>
<td>State Council of China</td>
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ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 900 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s web site: www.isda.org. ISDA® is a registered trademark of the International Swaps and Derivatives Association, Inc.

ABOUT KING & WOOD MALLESONS

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