

# China contract boot camp: How foreign businesses can avoid entering into contracts involving "fake content with a genuine chop"

December 2019

Under normal circumstances the fact that the parties to a contract have imprinted seals (or 'chops' as official company seals are called in China) would typically indicate that the parties have reached an agreement on the contents of the contract and are ready to perform it. However, in practice, there are still cases where the official seal of one party is genuine, but senior management of the company in question has no knowledge of the contract until the time comes when it is called upon to perform its obligations or receives a court summons. We have worked on several such disputes involving foreign-invested enterprises (FIE) in recent years. In this note, we will look at how this phenomenon came about, discuss how to prevent it happening, and how to deal with disputes arising in this area.

## Case background

### Case 1:

A well-known FIE financial services industry player (Company A) received a lawyer's letter from Company B, a demand to perform a Letter of Undertaking and pay a large amount in commission. This demand came completely 'out of the blue', although it related to a genuine tender process in relation to which Company A had submitted a successful bid back in the day. Company A headquarters senior management were completely unaware of the existence of such Letter of Undertaking, and the contents of the letter were in clear violation of Company A's internal rules. Therefore, it refused to comply with the demand from Company B. Subsequently, Company B brought a lawsuit against Company A. Since the Letter of Undertaking bore the seal of Company A, and in the absence of sufficient evidence in rebuttal, the court at first instance essentially upheld all of Company B's claims. Following an appeal by Company A, both parties finally reached a settlement.

### Case 2:

Similarly, Company C, an FIE, was informed out of the blue that its bank account had been frozen pursuant to a court order and later received a summons from the court: Company D was suing it for breach of a certain Cooperation Agreement and was demanding that Company C pay it a large amount in liquidated damages. The agreement bore the official seal of the Company C, even

though local management of Company C asserted they had never seen the agreement before. During the proceedings, the court ordered an assessment of the authenticity of the seal, and entrusted this to an independent appraisal institute, which finally confirmed that the seal on the agreement was indeed the seal of Company C.

### **The legal effect of a seal on a contract and the Chinese Supreme People's Court's views on this issue**

Generally, if an agreement bears a company's official seal it is presumed that each company has agreed its contents and that the agreement has taken effect between the parties, subject to any conditions to its effectiveness. However, it is important to realize that this is not an absolute rule in practice.

Article 32 of the *People's Republic of China Contract Law* effective 1 October 1999, stipulates that "Where a contract is entered into in the form of a contractual document, the contract is formed from the time that the parties sign or affix their respective seals onto the contractual document." Article 143 of the *People's Republic of China General Rules of the Civil Law*, which came into effect on 1 October 2017, sets out three requirements which must all be present in order for a civil legal act to be valid:

- i. The person(s) making the legal act must have legal capacity.
- ii. The expression of intention must be genuine.
- iii. The legal act must not violate any mandatory provisions of laws and administrative regulations and must not violate public order or social customs.

The above requirements i) and iii) are usually relatively straightforward to satisfy in practice, whereas most disputes center around item ii). That is, whether the content of the agreement represents the true intent of both parties.

The Supreme People's Court (SPC) clearly pointed out in a retrial case ((2014)Civil Ti No.178):

*"The act of contract formation and the affixing of the seal are relatively independent. The act of contract formation is a reflection of the agreement reached between both parties, while the act of affixing a seal is a confirmation of the agreement between the parties. The two acts are interrelated, but independent."*

*From an evidential point of view, the authenticity of the seal generally guarantees the authenticity of the act of contract formation. However, if there is evidence rebutting, or raising serious doubts regarding the genuineness of the consensual nature of the agreement, the authenticity of the agreement cannot be directly presumed merely on the basis of the authenticity of the seal. In other words, the seal is merely preliminary evidence in proving the authenticity of the agreement. The people's courts still need to comprehensively consider other evidence and relevant facts to confirm the authenticity of the agreement."*

This means that the SPC believes that when there is evidence which may rebut or cast reasonable doubt on the validity of contract formation, the courts must not rely on the authenticity of the seal alone to confirm whether a contract has been validly formed and that other evidence and facts need to be looked at in the round. This view undoubtedly gives us a clear direction in dealing with such cases. Although China is not a common law jurisdiction, the SPC has been promoting a guidance or model case system which operates in a similar way to case law in practice. This ruling is part of that system. Therefore, such precedents, especially judgments from the SPC, while not

technically binding on the lower courts, are highly authoritative when local courts have to deal with similar cases.

In addition, in judicial practice in China, there have been published cases in which enterprises have disputed the validity of contracts on the grounds that the official seal was not genuine, having intentionally carved multiple sets of official seals. Article 41 of the *Summary of civil and commercial trial work meeting of the national courts report*, just issued by the SPC on 8 November 2019, specifically states that when determining the validity of the contract, the people's courts must mainly examine whether the signatory had the right of representation or agency right at the time of sealing based on the relevant rules governing rights of representation or agency. This provides further support for the proposition that the courts must consider whether the contents of the disputed agreement corresponded to the genuine intention of the parties at the time, rather than simply making a decision based solely on the authenticity of the seal on the contract.

### Comments

It is clear that something has gone wrong with internal governance safeguards when a company's official seal is affixed on a contract but the company's senior management is unaware of the existence of that contract. Often you may never find out the real reason why the situation arose in the first place. In practice, the main reasons for this situation arising may include:

- **Management confusion.** The company's local management system may be disorganized, e.g., a third party may have been able to enter or leave the company's office due to a lack of security or after being helped by an insider; or the signature page of the disputed contract may have become mixed up with an everyday contract that the company intended to enter into (such contracts may sometimes only be one page long), such that the company's real seal appears on such contracts but was affixed in error. The company may only have unwritten, ad hoc or informal rules on the use of the chop e.g., you have to ask "X" before using the chop, so there is no paper trail as to whether the right questions were asked and the right escalation procedures followed.
- **Weak internal governance.** Any well-run company in China (whether or not an FIE) will have a properly thought-through chop custody and use policy, which means that all chops are in the physical custody of a given person or persons at all times, and they can only be signed in and out by certain designated persons who must leave behind a written record in the "chop book." In other words, at any given time the company is able to locate each of the chops and who has possession and use of the same.
- **Internal complicity.** Managers may have colluded with third parties, and may have used their powers to chop such contracts or allow chopping to take place, often to further their own interests. This may be very difficult to prove. Chinese companies, particularly State-owned Enterprises tend to be very hierarchical, so saying "no" to a senior person on the basis it violates internal procedures is not really a practical option.

### Severe consequences

Although these cases are not particularly common, the consequences can be extremely severe, and may cause the company to suffer serious unbudgeted losses. The official seal on the contract may be genuine and both parties to the contract may still be in an ongoing business relationship, which may cease to exist as a result of the bad blood created by the dispute, giving rise to an additional financial impact. Although the SPC's precedents give a basis for defending such claims, it remains extremely difficult in practice to produce evidence that is sufficient to rebut validity when the seal is genuine, due to timing issues and other reasons. In case one we were able to

submit a large amount of new evidence at the appeal stage, proving that the contents of the Letter of Undertaking were illogical, unreasonable and completely out of character with Company A's culture. This was enough to cast doubt on the genuineness of the contents in the mind of the judge. However, given that the evidence in such cases is often indirect and circumstantial, often the best or only way for clients to get out of the dispute is settling with the plaintiff, because the exact circumstances of what actually happened are either (a) already forgotten, (b) those who were there at the time have already left the company, or (c) people who know what happened are still there would implicate themselves by "remembering." The court finally "forced" the other party to mediate with our client which prompted a settlement.

As for the defense that the other party sneaked into the company's premises sealed the contract and left without being seen, it is nearly impossible to produce evidence to prove either way, and it is difficult to imagine a scenario where this could happen in practice without help from an insider. It is often difficult to separate fact from fiction when the company goes into "blame game" mode, where everyone who is still at the company tries to deflect blame away from themselves onto others, particularly onto those who have long since left the company and are untraceable or have no incentive to testify.

### **Lessons learned**

For these reasons, we recommend that all enterprises in China, and especially those FIEs that place heavy reliance on local management teams, establish strict rules on the custody and use of the official company seal (as well as other special-purpose seals):

- Draw up clear contract approval rules and business criteria and notify all relevant personnel in a way that can be easily evidenced in the future (e.g., email).
- Empower staff to enforce them by ensuring "no revenge, no punishment" for reporting violations, regardless of by whom.
- Formulate business contract templates for the company that must be used in all cases absent senior management approval; ban all other forms absent express documented consent by senior management.
- Require both the official seal and signature of the legal representative at the same time; The legal representative may act as an additional layer of protection as he/she will not want his/her name to be on a document that clearly violates company policy and/or is obviously prejudicial to the company's interests.
- Keep a clear and orderly register of all contracts. Use serial numbers or other systems to keep track.
- Publish a chopping custody and use policy and enforce it rigorously with a chop signing in/out book held by the chop custodian(s). Do regular spot checks to ensure it is being used.

### **Get help**

At the same time, in the event of a dispute the company must promptly employ experienced lawyers to intervene, carry out internal compliance investigations, and actively collect evidence. Defending a case that suggests bad faith and feels like extortion is frequently traumatic as it raises issues about how the company got itself into that situation and potential collusion, but collusion is notoriously hard to prove without the help of a whistleblower. For example, in such cases, helpful evidence may be evidence establishing that the contents of the contract involved in the case are obviously inconsistent with past business practices and of the company's previous

approach in relation to such activities, as well as relevant evidence that the so-called "agreement" has not been and was never intended to be actually performed, and so forth. It is not a one-size-fits-all approach. Specific defense strategies and countermeasures must be devised based on different circumstances and on the facts of each case.

## Conclusion

Above all, it is important for companies, including but not limited to FIEs, to learn from these incidents and minimize the going forward risks by putting in place robust policies and procedures around contract management and the custody and use of chops. Companies that are the victims of fake contracts need to make sure that lessons are learned. The managers of those victim companies and/or their parent companies also need to keep an open, but skeptical mindset when presented with various versions of the facts, as the mere fact this has happened suggests a compliance or communication failure that needs to be addressed; they should be prepared to show zero tolerance by taking disciplinary action against anyone who has abused the chops out of self-interest, but should also protect genuine whistleblowers. The challenge in these cases is always finding evidence to show bad faith, whether by an insider or a counterparty, with the parties often ending up in a sterile "he said, she said" type of argument that in the final analysis tends to favor the plaintiff who asserted the claim, as it does little to rebut the underlying basis of the claim.

## Contacts



**Andrew McGinty**  
Partner, Hong Kong  
T +852 2840 5004  
[andrew.mcginty@hoganlovells.com](mailto:andrew.mcginty@hoganlovells.com)



**Suyu Yuan**  
Deputy Director and Counsel, Hogan Lovells  
Fidelity  
T +86 021 2070 4818  
[suyu.yuan@hoganlovellsftz.com](mailto:suyu.yuan@hoganlovellsftz.com)

**[www.hoganlovells.com](http://www.hoganlovells.com)**

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