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Better protection of SMEs:

SPC Issues Landmark Reply on “Back-to-Back” Clauses

On August 27, 2024, the Supreme People’s Court of China (“SPC”) released the “Reply on the Effect of the Clause Where Large Enterprises and Small and Medium-sized Enterprises (“SMEs”) Agree to Pay by Third-Party Payment as a Precondition” (the “Reply”, in Chinese, “《关于大型企业 with 中小企业约定以第三方支付款项为付款前提条款效力问题的批复》（法释〔2024〕11号）”), which signifies a pivotal change in the legal approach to “back-to-back” clauses.

This Reply, consisting of two articles, clarifies the legal application issues concerning the validity of such clauses and the determination of payment terms and corresponding default responsibilities after the recognition of invalidity of “back-to-back” clauses. It is aimed at ensuring SMEs’ fair participation in market competition, and safeguarding the legal rights of SMEs.

“Back-to-Back” Clause Controversy

The “back-to-back” clause, refers to the contractual stipulation that a party pays the counterparty upon receiving payment from a third party or in proportion to the progress payment allocated by the third party.

Prior to the issuance of the Reply, the determination of the validity of the “back-to-back” clause did not require company types of contracting parties to be Large enterprises and SMEs. The prevailing view was that it was in line with the transaction customs in the field of construction engineering. Additionally, the “back-to-back” clause was considered a reflection of the true intent of the parties and as such the court should respect the risk allocation under party autonomy. For example, Article 22 of the *“Answers to Several Difficult Issues in the Trial of Construction Engineering Contract Dispute Cases”* (in Chinese, “《关于审理建设工程施工合同纠纷案件若干疑难问题的解答》”) by the Beijing High People’s Court stipulates that in subcontracts, the agreement that the general contractor will pay the subcontractor after the general contractor has settled with the owner and the owner has paid the project funds is valid.

Legal basis

However, the Reply has marked a departure from this traditional perspective. The legal basis for the validity of “back-to-back” clauses lies in the “Regulations on the Payment of SMEs” (the “Regulation”, in Chinese, “《保障中小企业款项支付条例》”) and the Civil Code of the People’s Republic of China (“Civil Code”).

Article 6 of the Regulation stipulates that large enterprises shall not require SMEs to accept unreasonable terms of payment, methods, conditions, and liability for breach of contract, and shall not default on payments owed to SMEs. Article 8 mandates that large enterprises should reasonably agree on payment deadlines and make timely payments. According to the SPC, the Regulation falls under the category of administrative regulation, and the aforementioned provisions are, in nature, mandatory provisions as stated in Article 153 of the Civil Code. **Therefore, the act of large enterprises attempting to shift risks through back-to-back clauses constitutes a violation of the mandatory provisions of administrative regulations, and according to Article 153 of the Civil Code, such clauses should be deemed invalid.**

Additionally, the SPC also recognizes that SMEs typically lack the bargaining power to negotiate fair terms with larger entities and often accept onerous conditions to ensure survival. The court has emphasized that “back-to-back” clauses, which would force SMEs to bear the risk of third-party payment delays, default or bankruptcy, are unfair and contradict national policies promoting a supportive business environment and fair market competition.

Application Scope of the Reply

The Reply specifically targets contractual disputes over “back-to-back” clauses in contracts signed between large enterprises and SMEs. Contracts signed with government agencies and public institutions are not within its scope.

The classification of large enterprises and SMEs mainly refers to the National Bureau of Statistics' 'Statistics on the Classification of Large, Medium, and Small Enterprises (2017)' (in Chinese, "《统计上大中小微型企业划分办法(2017)》") and the Ministry of Industry and Information Technology's "Regulations on the Size of Small and Medium Enterprises" (in Chinese, "《中小企业划型标准规定》(工信部联企业〔2011〕300号)").

Consequences for invalidity of "back-to-back" clauses

In cases where "back-to-back" clauses are deemed invalid, for specific cases, courts shall determine the specific payment terms based on industry practices and relevant regulations.

The invalidity of the "back-to-back" clauses does not affect the validity of other terms and conditions of contract such as settlement and payment conditions.

Regarding default responsibilities, the Reply emphasizes respecting the autonomy of the contracting parties. If there is an agreed interest calculation standard, it should be followed. In the absence of such an agreement or if the agreement is illegal, the default interest should be calculated based on the one-year Loan Prime Rate (LPR) issued by the National Interbank Funding Center.

Relevant cases

On July 26, 2024, the People's Court Case Database (in Chinese, "人民法院案例库") added three new cases, which also negate the validity of the "back-to-back" clause from different dimensions. We summarize the facts and highlights of the three cases:

- Case One¹:

This case involves a construction company that signed a contract with another company for construction work. The contract included a "back-to-back" clause stating that payments to the construction company would be made upon receipt of funds from the project owner. The court ruled that despite the contractual agreement, the paying company could not use the "back-to-back" clause as a reason to delay payments when the project had been completed and the owner had entered bankruptcy proceedings. The court emphasized the principles of fairness and good faith, requiring the paying company to settle the outstanding payment to the construction company.

- Case Two²:

A supplementary agreement between a construction engineering company and its subcontractor included a clause that allowed for the deferral of payments from the main contractor to the subcontractor if the owner delayed payments. The court found that this clause could not serve as a valid reason for the main contractor to indefinitely postpone payments, especially when there was no evidence of the owner's delay. The court held that the main contractor should have fulfilled its payment obligations in accordance with the contract and the principles of honesty and credit.

- Case Three³:

A materials company entered into a sales contract with an engineering company for the supply of construction materials. The contract contained a "back-to-back" clause linking the payment for materials to the engineering company's receipt of funds from the project owner. The court determined that this clause did not constitute a valid payment condition, as it did not align with the materials company's contractual purpose of receiving payment for the goods supplied. The court rejected the use of the "back-to-back" clause as a basis for the engineering company to avoid its payment obligations, citing the need for the company to independently bear the commercial risks associated with the project owner's payment capabilities.

Conclusion

The SPC's Reply underscores a critical shift towards safeguarding the interests of SMEs in contractual agreements when large enterprises default on their debts to SMEs. By declaring "back-to-back" clauses invalid, the SPC has expressed the attitude that ensuring fair participation of SMEs in market competition and safeguarding the legitimate interests and rights of SMEs..

The Reply serves as a clear directive to the judiciary and a reminder to the business community that contractual fairness and the equitable distribution of risk are cornerstones of China's legal and economic framework. It is expected to level the playing field, empowering SMEs to negotiate and operate with greater confidence, and fostering a more robust and resilient marketplace.

As the implications of the application of the Reply continue to be felt across industries, it is a timely reminder especially for SMEs to review their contractual practices and align them with the updated legal standards.

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