CHINESE CONTRACT LAW

Theory and Practice

by
Mo Zhang

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Preface

With the vast growth of Chinese economy in the world for the past decades, the rising interest in Chinese law and legal system in the international community is fascinatingly accelerated. It is not only because the opening-up policy that China has been vigorously pursuing since 1979 has awaken the country that used to be commonly described by the west as the far-east "sleeping lion", but also because there has been an increasing need generated by business drives as well as commercial and other interests in the west for actively dealing with China. However, partly due to the language barriers that prevent many in the west from knowing China on the first hand basis, and partly, perhaps most importantly, because the Chinese ideology and system to certain extent look fundamentally different from those with which people from west are familiar.

A British businessman and ambitious investor who worked in China for sixteen years trying to figure out the myth of the country encountered by foreigners was on the one hand amazed by the rapid changes that took place in China everyday, and on the other hand still from time to time found himself frustrated, desperately struggling for the glory that had been hoped. In his book, named 'Mr. China", he began his China story with the following very interesting comments:

> "The idea of China has always exerted a pull on the adventurous type. There is a kind of entrepreneurial Westerner who just can't resist it: red flags, a billion bicycles and the largest untapped market on earth. What more could they want? After the first few visits, they start to feel more in tune and experience the first stirrings of a fatal ambition: the secret hope of becoming the 'Mr. China' of their time, the *zhongguo tong*, or 'Old China Hand' with the inside track in the Middle Kingdom. In the end, they all want to be Mr. China. They want to be like Marco Polo roaming China as the emissary of the Kublai Khan. Or

> the first pioneering mill owners lolling about in the opium dens in Shanghai, dreaming of the fortune to be made if every Chinese would add an inch to his shirttails. . . . And of the countless businessmen who come to China with high hopes of the 'billion three market', how many long to become the ultimate China hand, the only outsider, the first and only *laowai* to crack China? But in the end, it's an illusion."[1]

For foreign lawyers, especially lawyers from the west, things become even more complicated. First of all, Chinese law and legal system look remote to them not in terms of geographical distance but in terms of legal substances. Many legal concepts that they deal frequently with at home may not be seen in Chinese law, and reversely there are legal terms that are common in China but may have no equivalent in any foreign legal system. Secondly, Chinese law and legal system are embedded with the tradition that evolved from the country's several-thousand-year history and still affects the way the legal norms are observed and enforced. The most distinctive tradition is the Confucianism that greatly emphasizes the moral standards over the formal law. Thirdly, social and political structure of the nation, particularly the one-party dominated government, sharply differentiates China from many other countries where the constitutional framework of separation of powers serves as the foundation on which the law and legal system are premised.

Therefore, knowing China is one thing, but understanding China is another. According to Professor John H. Merryman of Stanford, there are three highly influential legal traditions in the contemporary world, namely civil law, common law, and socialist law.[2] China obviously is regarded as the country that falls within the category of "socialist law" tradition. Although the rationality of such division is subject to debates, the countries that seem to bear the "socialist law tradition" are clearly separated from the rest of the world. A remarkable nature of the "socialist law tradition" is, as described by many, its underlying attitude that all law is an instrument of economic and social policy.[3] But despite the distinction, the "socialist law tradition" is characterized in general as the principles of socialist ideology plus civil law tradition, which was labeled as the product of the Russian October Revolution 1917.[4]

The modern Chinese law and legal system are, as a matter of fact, in an evolving stage without a definite model of tradition. Before 1949, China was in a nearly 40-year period (since 1911) of warlord chaos, anti-Japanese war and then civil law, during which the country was struggling both internally

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[1] See Tim Clissold, *Mr. China*, preface (Robinson, 2004).

[2] See John Henry Merryman, *The Civil Law Tradition* (2nd ed), 1 (Stanford University Press, 1985).

[3] See *id*., at 4.

[4] See *id*.

and externally for peace and stability, and thus the development of law and legal system was barely in anybody's mind although the Code of Six Laws (*Liu Fa Quan Shu*) was adopted by the nationalist government.[5] After 1949 until 1979, China was dragged into nowhere by Chairman Mao's philosophy of political struggle with a failed attempt to find a real socialist system for the country. Since 1979, the opening-door policy has led China to move toward prosperity. In the meantime, the country has been rebuilding its legal system under the doctrine of "Chinese reality with reference to foreign laws and legal systems". As a result, numerous laws and regulations were adopted and many of them, as they can be easily discerned, were the mixture of legal rules and methodologies of different countries or legal systems.

But, in a broad sense, Chinese legal system has an origin of civil law tradition. It is mainly because in the modern history, China was strongly influenced by such civil law countries as Germany and Japan. In addition, in early 1950's, China made all efforts to base its laws and legal system on the model of the former Soviet Union, which was basically still the French style civil law tradition. For example, in contrast to the common law countries where the court decisions are the major sources of law, China has a statutorily based legal system, which means that the courts, when making decisions, are primarily, if not only, bound by the statutes. Another example is the structure of the statute. Almost every major laws of China have a general part (also called general provisions) that addresses the general principles of the law and the principles are required to be applied crossly with the particular provisions of the law. This structural distinction has its root in German law (e.g. the German Civil Code).

Still, a common viewpoint from many foreign observers is that China is lack of the rule of law. However, it seems to be a misconception that China has no law at all despite that the term of the rule of law is being interpreted in different ways. The fact is that in the past two decades, China has been in the stage of mass legislation and as a result, thousand of laws in the form of statutes were adopted in the country. A closer look at the laws enacted by the National People's Congress of China further reveals that many of the laws are well written both structurally and in substance. The major challenge facing China in the process of development of the rule of law actually is how to effectively enforce the laws. It would require China not only to build a system under which the laws will be fairly implemented, but also to establish a mechanism

[5] The Six Laws were Constitutional Law, Civil Law, Criminal Law, Civil Procedure Law, Criminal Procedure Law, and Administrative Law. Note that the early version of the Six Laws had Commercial law instead of Administrative Law.

by which the public awareness of the importance of the observance of laws will be significantly increased.

This book is intended to provide an insight view of Chinese legal system through the law of contract for at least two reasons. First, the contract is the area where the basic economic order and business transactions structure of China are generally affected. It is also the area in which the effectiveness of the legal system of the country is tested. Second, contract law is one of the frontiers in China that often directly involve international business dealings and engage the people's courts in dispute settlement process that has foreign litigants or foreign elements. Of course, the focus of the book is on the theories that are developed in China in all areas of contract and the practices in which the matters of contract are actually dealt with.

The book begins with a review of the legislative history of contract law in the country, and then moves onto an analysis on the Chinese nature of contracts. With regard to the contract system in China, all discussions in the book are primarily based on the Contract Law that was adopted in 1999. The Contract Law is divided into two parts: general provisions and specific provisions, but the book mainly covers the general provisions because the general provisions are deemed as the core of the Contract Law though the specific provisions have their significance as applied to each particular type of contract. From Chapter III, each chapter of the book has a special concentration on certain subject of the law of contract, such as formation, defenses, performance, assignment, breach and remedies, as well as third parties. The last chapter of the book addresses the issues in international contracts since those issues are provided separately in the Contract Law due to the foreign nature of such contracts.

An attempt is made to include as many cases as possible in the book to help illustrate how the Contract Law is applied in the people's courts adjudicating contract cases. But keep in mind that case law is not an authoritative legal source in China because of its civil law tradition. And additionally, in the past, the cases rendered by the people's courts were not published in the country. For the need of legal study and research, scholars had endeavored to publish certain selected cases, but many of these cases contained no name of the parties and the key facts were edited to avoid referring to the parties involved in the cases. The underlying notion was that a civil litigation between the parties was the private matter of the parties and was not supposed to be made public without the consent of the parties. Therefore, the cases decided by the people's courts were not deemed as public records in China.

Even for the selected cases that were published, there was barely any reasoning in the court decisions. Historically, a typical Chinese people's court decision was short and normally had three parts: statement of facts alleged by each of the parties and found by the court, statement of applicable provisions of law, and rulings of the court. What was lack then was the analytical reasoning

on which the court relied to render its decision. There were at least two attributes to this phenomenon. First, since the court was not expected to make its decision available to anybody other than the parties, it would be practically easier for the court to just tell the parties what the decision is without giving any reasons. Second, in many cases the decision was actually determined by a trial committee in the court, not by the judge himself, and therefore it did not necessarily reflect the position or opinion of the judge himself who handled the case. Another concern in this regard was, perhaps, the appellate review of the case upon appeal. Since the reasoning would require the creative thinking of the judge, it might be the most obvious part subject to the review by the appellate court. In many courts, the rate of reversal by the appellate division served as an indicator of the merits of the performance of the judge.

Nevertheless, as part of its efforts for judicial reform, the Supreme People's Court has been making a hard push in the judiciary for being transparent by requiring the people's courts to do two things: (a) to make the court decisions public and (b) to add legal reasoning into the decisions. In April 2003, the Supreme People's Court itself started to publish its decisions, and in the meantime the Supreme People's Court periodically published as models the selected decisions made by lower people's courts. According to the Supreme People's Court, the purpose for doing this was, among others, to improve the quality of the writing of the judicial decisions and help maintain the impartiality of the judiciary by making the court decisions under the public review. In order to achieve this goal, it is critical that the judge through the legal reasoning tells why the decision shall be made in certain way.

At this point, however, not every case of all people's courts is yet to be published. Therefore, a certain number of the cases used in this book were not published. But the good thing is that to get access to the unpublished cases from the courts now is generally not an offense to anyone. It then can be predicted that more and more cases will be published in China in the near future. In any event, it should, once again, note that no case at higher level of the people's courts of China could become precedent to bind lower courts although the decisions made by the Supreme People's Court may have strong effect of guidance to all people's courts.

Mo Zhang
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Introduction

On March 15, 1999, the National People's Congress of China (NPC) – the Chinese national legislative body – adopted the Law of Contract of the People's Republic of China (Contract Law). Effective on October 1, 1999, the Contract Law is regarded as the most significant legislation regulating civil and commercial affairs in the nation.[1] It not only unified all previous contract law legislation, but also marked the beginning of comprehensively regulatory stage of contracts in modern China since 1949 when the People's Republic of China was founded.

In Chinese history, a contract was commonly termed as an agreement, and the written form of agreement as used in dealing with civil affairs could be traced back in as early as the West Zhou (1100 to 770 BC).[2] During the West Zhou period, "agreement", known in Chinese as "*Qi Yue*" was adopted to record the consent of two parties for their exchange of goods or purchase of lands as well as other civil activities such as loan and lease. On certain occasions where the transaction (exchange) was deemed important, the process and the terms of the transaction were engraved in the bronze tripod as the evidence of the transaction, and the engraved agreement was also called "Certificate of Agreement" (*Qi Juan*).[3] Since West Zhou, agreement, from dynasty to dynasty,

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[1] See Gu Angran, *A talk on Contract Law of the People's Republic of China*, 1–5 (Law Press, 1999).

[2] For general information, see Zhang Jinfan, *Evolution of the Chinese Legal Civilization*, 55–56 (China University of Political Science and Law Press, 1999).

[3] See *id*.

had become the major form representing consent of parties in their civil activities and evidential document of the meeting of minds of parties concerned.

Ironically, however, the contract did not play any active role in the People's Republic of China for several decades until 1980's. Factors attributive to this phenomenon were many. The most notable factor was perhaps the planned economy that dominated all civil activities in China. Another significant factor was the ideology of absolute subordination of private interest to public one – the golden rule that governed the country for a considerably long period of time in the modern history of China.

1. Chairman Mao's "Plain Paper" Theory and Legal Vacuum in China

When the Chinese Communist Party (CCP) took the power in October 1949, all then existing laws and regulations promulgated by the Nationalist government were regarded as evils and therefore ought to be eliminated. The process of cleaning-up of the old laws actually began in January 1949 when the CCP issued an announcement to be put forward on the table for the peace talks with the KMT-Kuomingtong (Nationalist Party), which demanded the abolishment of the constitution and laws adopted under the KMT regime. One month later, in February 1949, the Central Committee of the CCP issued the Directives on the Abolishment of the Code of Six Laws and the Establishment of Judicial Principles in the Liberated Areas. The Directives annulled all laws and regulations that were effective under the KMT government.[4]

Mao Ze Dong highly appraised the abolishment of the KMT legal system and poetically described the new system that replaced the old one as a piece of "Plain Paper" (or a blank sheet of paper). According to Mao, "there would be no burden bearing with a piece of plain paper, on which the newest and most beautiful words could be written and the newest and most beautiful pictures could be drawn."[5] Under this "Plain Paper" philosophy, Mao started his ambitious socialist construction in China, and built Chinese economy under the model of former Soviet Union – known as the planned economy.

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[4] See Xin Chunying, Chinese Legal System and Current Legal Reform, 325–327 (Law Press, 1999).

[5] Mao Ze Dong, *Introduction of A Cooperative Unit*, The Selected Papers of Mao Ze Dong 1 (People's Publishing House, 1985).

In the early years of 1950's, attempting to help China recover from the wreckage of the civil war (1946–1949), the central government of China made efforts to regulate the economy through certain legal means. In September 1950, for example, the Administration Council (later replaced by the State Council in 1954) through its Commission of Finance and Economy issued "Provisional Methods on Contractual Agreement Made between Government Agencies, State Enterprises, and Cooperatives".[6] Under the Methods, it was required that a contractual agreement be made for major business activities between government agencies, state enterprises, and cooperatives. The major business activities as listed in the Methods included loans, collection and payment under agency, sales of goods, products made to order, barters, entrusted receipts and sales, out-sourced processing, lending money or items by mandate, entrusted transportation, renovation and construction, concessionary business operation, as well as joint ventures.[7]

On September 20, 1954, the first Constitution of China was adopted – known as the 1954 Constitution.[8] According to the 1954 Constitution, the National People's Congress (NPC) was empowered as the top legislative body in the nation.[9] Under the requirement of the 1954 Constitution, the NPC started to draft major laws, and one of which was the "Civil Code". In October 1955, the General Principles of Civil Law of China was first drafted and it contained the basic principles, the subject of rights (person), the object (also translated as the subject matter) of rights, the legal acts, and the statute of limitation.[10] In December 1956, the first draft "Civil Code" was complete, which included four parts – General Principles, Ownership, *Obligatio* (*zhai*) and Inheritance – with a total of 525 articles. In the *Obligatio*, contract was the major component. Unfortunately however, the process of drafting was interrupted in 1958 as a result of the Anti-Rightist Campaign against intellectuals

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[6] See Wang Liming, *A Novel Discussion on Contract Law – General Principles*, 11–12 (China University of Political Science and Law Publishing House, 1996).

[7] See Wang Liming, *id*.

[8] From 1954 to 1982, there were four constitutions that were adopted in China in 1954, 1975, 1978 and 1982 respectively. The current Constitution is the 1982 Constitution, which has been amended four times since it was adopted on December 4, 1982. The four Amendments to the 1982 Constitution were made 1988, 1993, 1999 and 2004 respectively.

[9] *See* Xu Chongde, *Constitution,* 241–242 (People's University Press, 1999).

[10] See He Qinghua, et al, *General View of Civil Code Drafts of New China*, Volume I, 3–11 (Law Press, 2003).

launched in 1957,[11] and consequently, the drafting work of the "Civil Code" inevitably aborted.[12]

After the Anti-Rightist Campaign, China actually was led to a period of legal vacuum. In August 1958, Chairman Mao in a special session of CCP's political bureau meeting in Bei Daihe clearly remarked: "the law was something we should have, but we did have our own stuff".[13] According to Mao, it would be impossible to rule the majority on the basis of law, but what is important was the customs that people were used to because the provisions in a law were too many to be remembered. Mao took himself as an example and said, "Though I participated in the drafting of Constitution, I could not remember any part of it". It was Mao's belief that every decision made by CCP was the law, and even the party's meeting minutes would also become the law.[14] As an echo to Mao's speech, the CCP Working Group of Politics and Law sent a report to Mao and CCP Central Committee on December 20, 1958 emphasizing that under the real situations in China, there was no need at all to adopt civil law, criminal law as well as procedural laws.[15]

The nationwide "crop failure" in early 1960's,[16] which resulted in severe famine in modern Chinese history during which millions of people died of starvation, shocked the CCP and the central government of China. In an attempt to take the nation back to the right track of economic construction from Mao's class struggle, Mao offered to step aside to play a secondary role

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[11] Anti-rightist campaign was the national "class struggle" launched by Chairman Mao against intellectuals in 1957 in response to the criticism the intellectuals made to the CCP and central government at Mao's invitation. The criticism began in 1956 when Mao initiated a policy of "Letting Hundreds of Flowers Blossom and Letting Hundreds of Thoughts Contend" in order to promote "people's democracy". See Yin Xiaohu*, New China's Road of Constitutionalism* (1949–1999), 87–90 (Shanghai University of Communication Press, 2000).

[12] See Wang Jiafu, *Civil Law Obligatio*, 21 (Law Press, 1991).

[13] See Yin Xiaohu, *supra* note 11 at p. 90.

[14] See *id*. A well-known story about Mao's marital life with his wife Jiang Qin may help illustrate more about how Mao treated himself *vis-a-vis* the law and judiciary. At one time when Mao talked to his guards about his depression about his relationship with Jiang, Mao said that "if you want to devoice your wife, you could go to a court, but if I want to do the same, where should I go?"

[15] See Yin Xiaohu, *supra* note 11 at pp. 94–95.

[16] During the three years of 1960–1962, the country nearly collapsed because of the starvation. The official explanation was that the starvation was caused by the natural disaster plus the former Soviet Union's suddenly withdrawal of its aids to China. But it was believed that the tragedy was to a great extent the sequelae of the government's mismanagement during the "great leap forward" campaign nationwide from 1958–1960. See Stanley Lubman, Bird in Cage, Legal Reform in China after Mao, 80 (Stanford University Press, 1999).

in the government as a gesture of self-blame for the disaster. As a result, Liu Shaoqi came to the front and led the country to recover from economic drawbacks. Under this circumstance, the work on national legislation resumed. In July 1964, the second draft "Civil Code" was complete, where sales relation was one of the 15 chapters.[17] Unfortunately however, the effort to adopt the "Civil Code" in China was once again killed due to the "Cultural Revolution" that was launched by Mao in 1966 in order to knock out Liu Shaoqi and his followers who were labeled by Mao as the "representatives of capitalism".

2. Economic Reform and Reconstruction of Legal System

It was not until 1979 when China finally came out of the shadow of 10-year chaos of the Cultural Revolution the nation begun to rebuild its legal system along with the economic reform. After that, the normal civil legislation resumed in the sense in which all legislative activities started to move forward.[18] In 1982, four different versions of the civil code were drafted with an attempt to match up with the changes in the rapid economic reform that began in 1979. In each of these drafts, contact was an important and indispensable part.

However, the activity to enact the civil code was temporarily halted in 1982 because the NPC and its Standing Committee were not quite clear about what would need to be included in the civil code and how the civil code ought to be structured in response to the vast economic reform. In an attempt to better deal with the substantial changes resulting from the reform, the legislature narrowed its focus down on specific areas such as contracts and torts. The underlying rationale was that the separate piece of legislation in certain area would be more efficiently and effectively adapted to the changing economy than a single comprehensive civil code. In addition, the separate legislation would also help provide an experimental basis for a more sophisticated legislation at a later time. Therefore, the contract legislation was then separated out and became an independent one.

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[17] Under the 1964 draft, sales relation was defined as the relation that occurs between units, unit and individual, and individuals for purposes of meeting the needs of production and live, to retail commodities and sell other things according to the principles of voluntariness and equal value within the limits allowed by laws. See He Qinghua, *supra* note 10 Volume III at pp. 124–126.

[18] In July 1979, The Second Session of the Fifth National People's Congress passed seven major laws including Criminal Law, Criminal Procedural Law, as well as the Law of Chinese-Foreign Equity Joint Ventures. By the end of 1982, 26 new laws were adopted, and the most important one was the 1982 Constitution.

The economic reform that was aimed at opening China to the outside world (the west developed economies in particular) significantly changed China in many ways. First of all, China moved from a centrally planned economy to a market oriented economy,[19] which greatly helped China join the main stream world economy and become one of the fastest growing countries in terms of economic development in the past two decades.[20] The reform eventually sent China into the World Trade Organization (WTO) in 2001 after nearly 15 years tough negotiations with the west.

Secondly, China entered into a massive legislation period in which many laws were adopted to regulate the politically and economically changing society. Perhaps the numbers may speak themselves: during the 30 years from 1949 to 1979, there were about 134 laws that were adopted at the national level, and by 1979, only about 23 were still effective; From 1979 to the adoption of the Contract Law in 1999, thousands of laws and regulations were promulgated, and most of them were in economic areas. For instance, in the period of 1979 to 1982, the National People's Congress and the State Council adopted more than 300 laws and regulations in the first three years of the economic reform, of which some 250 dealt with economic matters.[21]

Thirdly, China became more and more eagerly as well as readily to absorb foreign "elements" – ideas and concepts. Foreign investment became the major component of the nation's economy. By the end of 2004, the number of approved foreign investment enterprises (FIEs) reached over 500,000 with a cumulated total direct foreign investment of $562.1 billion. Among Fortune 500, more then 400 companies have investment in China.[22] In legal area, taking foreign law and legal system as reference has been becoming an important

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[19] In 1992, the 14th National Conference of the CCP set it as the goal of China's economic reform to establish a system of the socialist market economy in China. One year late in 1993, the 1982 Constitution was amended to provide that the State pursues socialist market economy. It also provides that the State shall enhance economic legislation and improve macro-control (of the economy).

[20] According to Chinese President Hu Jingtao, China's GDP grew at an average rate of 9.4 annually for the past 26 years from 1978–2004. See Hu Jingtao, Keynote Speech at 2005 Fortune Global Forum (Beijing May 16–18). A full text of the Speech is available at http://politics.people.com.cn/GB/1024/3392948.html. For more detailed statistics see http://www.stats.gov.cn.

[21] See Xing Chuying, *supra* note 4 at pp. 348–349.

[22] See Hu Jingtao, *supra* note 20. For the details of the statistics, see the Ministry of Commerce of China (formerly MOFTEC), Statistics of Foreign Investment in China, available at http://www.mofcom.gov.cn.

part in the process of China's legislation. The purpose is to "get China connected with the world" – the very commonly used term that demonstrates China's stated commitment to the membership of the world economy.

3. Contract Law Legislation

The contract law legislation in China began in 1980 when the Economic Contract Law (ECL) was drafted. The drafting work started in October 1980 and the draft was sent to NPC for its review on September 29, 1981. The ECL was adopted on December 13, 1981 and went into effect on July 1, 1982. In essence, the ECL regulated contracts that were entered into for business purposes between legal persons, other economic organizations, individual businesses, and rural business households.[23] It is important to note that under the ECL the contact was termed as "economic contract" because at that time the contract was viewed as the legal means to realize economic goals as stipulated by the State plans.[24] Also important to note was that the ECL excluded natural person from making economic contracts. The ECL was amended in 1993 to reflect China's on-going economic reform. The most striking change in the amended ECL was the deletion of the provision that defined the purpose of economic contract as to guarantee the implementation of the state plans. However, the exclusion of natural person remained unchanged.

The second important piece of contract legislation was the Foreign Economic Contract Law (FECL), which was promulgated by the NPC on March 21, 1985. The FECL was designed to apply to the contracts where foreign party or foreign element was involved. Under Article 2 of the FECL, the law applied to economic contracts, concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises, other foreign economic organizations or individuals.[25] Once again, no Chinese citizen was allowed as an individual contracting party to enter into a foreign contract. In addition, the FECL did not apply to the contracts of international transportation.

On June 23, 1987, the Technology Contract Law (TCL) was adopted with a stated purpose of providing impetus to scientific and technical development

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[23] See *Economic Contract Law of the People's Republic of China*, an English translation is available at http://www.qis.net/chinalaw/prclaw19.htm.

[24] See Wang Shengming, *Introduction to the Contract Law of China and Important Drafts of the Contract Law*, 3 (Law Press, 2000).

[25] See *Foreign Economic Contract Law of the People's Republic of China*, an English translation is available at http://www.qis.net/chinalaw/prclaw20.htm.

in China. The application of TCL, however, was limited to the contracts between legal persons, between legal persons and citizens, and between citizens, which establish civil rights and obligations in technical development, technology transfer, technical consulting and services. It was the first time in the contract law legislation that the Chinese individuals were permitted to make contract. Because its intended domestic nature, the TCL did not apply to contracts in which one party is a foreign enterprise, other foreign organization or foreign individual.[26] In addition, the participation of Chinese individuals in making contract was limited to the technology contract only.[27]

The adoption of the TCL marked the beginning of China's "triarchy" period of contract law legislation, where three contract laws simultaneously operated to deal with contracts in respective areas. This practice not only caused much confusion about application of these laws, particular when a contract involved overlapping domestic, foreign and technology matters. But also, it resulted in the inconsistency among the contract laws because each contract law is different from the other in terms of terminology, contents, structures as well as the wordings of contractual principles.

For example, under the ECL, the contractual remedies were based on the principle of "fault", which meant that whoever at fault in case of breach would be responsible for the damages.[28] According to the FECL, however, a breaching party would be liable for the damages in case of breach regardless of the breaching party's fault.[29] Clearly, the FECL did not premise the contractual liability on the fault principle, but on that of strict liability. The conflicting liability principles in ECL and FECL indeed made it difficult, if not impossible, to apply these laws in a predictable and uniform way. Therefore, a call for a unified contract law in China inevitably became an appealing voice all over the nation ever since the ECL was amended in 1993.[30]

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[26] See *Technology Contact Law of the People's Republic of China*, an English translation of the law is available at http://www.qis.net/chinalaw/prclaw21.htm.

[27] The Technology Contract Law was not supposed to supersede any part of the Economic Contract Law.

[28] Article 29 of the ECL provided: "due to the fault of one party that causes economic contract not to be performed or not to be completely performed, the party at fault shall be liable for the breach of contract".

[29] Pursuant to Article 18 of FECL, in case of breach where one party fails to perform contract obligation or the performance fails to meet the terms as agreed upon in the contract, the other party shall be entitled to demanding damages or other reasonable remedial measures.

[30] See Wang Shengming, *supra* note 24 at pp. 4–5.

4. Enactment of the General Principles of Civil Law

Before the TCL was adopted, the NPC passed the General Principles of Civil Law of the People's Republic of China on April 12, 1986 (Known as 1986 Chinese Civil Code). There may have many reasons for the adoption of the Civil Code. The most compelling one was the need for a unified national legislation that regulates civil affairs (rights and obligations) taking place in the economic reform and establishes a common legal norm for the nation's booming civil activities to follow.[31] Another reason seemed to be that both the ECL and the FECL had provided useful experiences for the legislators to identify the legal issues involving civil matters and to regulate some of the civil matters in a relatively comfortable way.

Originally, a comprehensive civil code was intended. Between 1980 and 1982, four drafts of the civil code were made and all of them were named as "Civil Law of People's Republic of China". To be more specific, the 1980 draft (August 15, 1980) had 6 parts and 501 articles,[32] and the 1982 draft (May 1, 1982) consisted of 8 parts and 465 articles.[33] But at that time, many argued that it was still too early to adopt a comprehensive civil code because there were many uncertain factors arising from the on-going economic reform. As a compromise, therefore, a simplified civil code was adopted in the name of the "General Principles".

It is typical in Chinese legislation process that no provision will be adopted unless and until the top legislators (mostly the members of the Standing Committee of the National People's Congress) are sure that (a) the provision is not in conflict with the national policy (set forth by the Communist Party), (b) substance of the provision is not too controversial and (c) the application of the provision will not cause any social unstability.

Nevertheless, the Civil Code, effective on January 1, 1987, was indeed the most important piece of civil law legislation in the modern China. It marked the new era of the Chinese civil law legislation, in which for the first time since 1949 China began to have its statutory civil law. According to Professor James Gordley at Boat Hall in Berkeley, "with the enactment of the Chinese Civil Code, systems of private law modeled on those of the West will govern nearly the entire world."[34] Though termed as General Principles, the Civil

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[31] See Wang Jiafu, *supra* note 12 at pp. 24–25.

[32] See He Qinghua, *supra* note 10, Volume III at pp. 371–435.

[33] See *id*. at pp. 560–622.

[34] See James Gordley, *the Philosophical Origins of Modern Contract Doctrine*, 1 (Clarendon Press, Oxford, 1991).

Code from its adoption has become the very basic law that governs and regulates personal and property relationships between citizens, citizens and legal persons, and between legal persons.[35]

The Civil Code contains ten articles on contract, and most of these articles deal with principal rights and obligations pertaining to a contract. In common with the civil law tradition, the Civil Code characterizes contract as a major component of *obligatio* (*Zhai*). Originated in Roman law, the term *obligatio* refers to both rights and obligations (*obligatio civilis*) created by certain civil relations such as contract (*obligatio ex contractu*), torts (*obligatio ex delicto*), or unjust enrichment (*obligatio quasi ex contractu*).

Under the Civil Code, the *obligatio* is a special relationship of rights and obligations established between the parties concerned, under either the agreed terms (contract) or legal provisions (torts). The party entitled to the rights shall be the obligee (creditor), and the party assuming the obligations shall be the obligor (debtor).[36] The Civil Code further provides that the obligee shall have the right to demand that the obligor fulfill his obligations as specified by the contract or stipulated by law.[37]

The Civil Code did have many flaws. In its provision dealing with the coverage of the Civil Code for example, there are two major issues that cause many criticisms. The first one is the use of citizenship to define the individual subject (person) of the civil relations. Article 2 of the Civil Code provides that the civil law of the People's Republic of China regulates property and personal relationships between citizens, legal persons, and between citizens and legal persons of equal civil status.[38] The problem is that by using the term "citizen", it would limit the general application of the Civil Code to Chinese nationals. Also as many argued, the "citizen" is a constitutional or political term other than a civil legal term. The second issue is the miss-out of the non-legal persons (e.g. partnership) as the civil subjects, which makes the coverage of the Civil Code actually incomplete.

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[35] On April 2, 1988, the Supreme People's Court issued "Opinions (Provisional) on Several Matters Concerning Application of the General Principles of the Civil Law of China". The Opinions consist of 8 parts and 200 articles, which were deemed as the primary legal document guiding the courts all over the nation to deal with civil law matters. The Opinions were revised on December 5, 1990, and the revised Opinions contain 230 articles in total. A full context of the 1990 Opinions in Chinese is available at http://www.law-lib.com/law/law_view.asp?id=15743.

[36] See General Principles of Civil Law of the People's Republic of China (GPCL) art. 84. An English translation of the full text of the GPCL is available at http://www.qis.net/chinalaw/prclaw27.htm.

[37] See *id.*

[38] See *id*.

5. The Unified Contract Law

The fast-going economic reform in China posed great challenges to the co-existence of different contract laws that caused difficulties in application. In 1993, the Standing Committee of the NPC decided to start drafting the Contract Law to unify the nation's contact law regime. The first draft was submitted to the Legislative Affairs Commission of the Standing Committee of the NPC in January 1995. And then four drafts were made thereafter in October 1995, June 1996, May 1997 and August 1998 respectively. The August 1998 draft was also published nationwide for comments and suggestions from the public on September 7, 1998. The Standing Committee of the NPC then made four reviews of draft before it was submitted to the vote in the NPC's General Assembly Meeting in March 1999.[39]

It is worth mentioning that during the drafting of the Contract Law, the Chinese legislative body, at the first time, invited scholars and lawyers from the west to offer comments and opinions. In October 1997 and December 1998, the Legislative Affairs Commission sent two delegations to the United States, Canada, the United Kingdom and Germany to visit universities, institutes, government agencies, courts, companies and law firms in these countries. The purpose of the visit was aimed at "directly taking foreign laws as references".[40] In addition, the Office of Legislative Affairs Commission also invited a group of American Lawyers in Beijing through Amcham – Beijing (American Chamber of Commerce in Beijing) to discuss the draft contract law and to offer advisory opinions on certain matters in the draft such as provisions on "offer and acceptance".

The Contract Law consists of 23 chapters and 428 articles, which are divided into three parts, namely, General Provisions, Specific Provisions, and Supplementary Provisions.[41] In the Specific Provisions, 15 types of the contracts are listed and addressed separately. Under the Chinese jargon, the 15 contracts listed in the Contract Law are the named contracts, and any others will then be deemed unnamed contracts.[42] Literally speaking, the named contracts

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[39] See Mo Zhang, *Freedom of Contract with Chinese Characteristics: A Closer Look at China's New Contract Law*, 14 Temple Int'l & Comp. L. J. 2, 237(2000).

[40] See Wang Shengming, *supra* note 24 at pp. 102–103.

[41] The General Provisions cover purposes, applications, and principles of the Contract Law, formation, effect, performance, or termination of the contract, and remedies for breach of the contract. The Specific Provisions deal with 15 different contracts such as sales, technology, and transportation. The supplementary Provisions state residual matters such as effective day of the Contract Law as well as repeal of three existing contract laws.

[42] The 15 named contracts are: Sales; Supply and Use of Electricity, Water, Gas and Heating; Donation; Loans; Lease; Financial Leasing; Work; Construction; Transportation; Technology; Storage; Warehousing; Commission, Brokerage; and Intermediation.

are considered as being used more frequently than the unnamed contracts. With regard to the law applicable to the unnamed contracts, the Contract Law adopts a doctrine of "application by analogy". According to Article 124 of the Contract Law, any contract that is not addressed explicitly in the Specific Provisions of this Law or in other laws shall apply the provisions of the General Provisions of this Law, and the most similar provisions in the Specific Provisions of this Law or in other laws.

Historically, as noted, the modern Chinese Law has a civil law (continental law) origin and many of legal principles contained in the Chinese legislation are rooted in Roman law, or more specific the German Law and Former Soviet Union Law (which has a French Law base). This scenario, however, seemed to have changed. As noted, in recent years, China has shown increasing interest in directly borrowing rules and legal concepts from common law system.[43] The Contract Law typically reflects this trend.

Several changes can be seen from the Contract Law. First, the Contract Law itself is a hybrid of civil law and common law literature, though the civil law tradition still dominates. For example, the Contract Law adopts the concept of "anticipatory repudiation" which is borrowed from American contract law.[44] Article 94 of the Contract Law provides that a contracting contract may rescind the contract if . . . (b) the other party to the contract expresses explicitly or indicates through its acts, before the performance period expires, that it will not perform its major contractual obligations. Article 108 further provides that where one party to a contract expresses explicitly or indicates through its conduct that it will not perform the contract, the other party may hold it responsible for the breach of contract before the performance period expires. More discussion about this article will be covered in other chapter of the book.

Another example is the provision of offer and acceptance, which is for the first time provided in the Chinese contract legislation.[45] Under Article 13 of the Contract, parties shall enter into a contract in the form of an offer and acceptance. It is also provided in Article 14 that offer is a manifestation of

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[43] The invitation of a group of US attorney in Beijing to discuss the draft contract was a clear signal that taking foreign law as reference has become a major part of the process of China's legislation.

[44] See also Liming Wang, China's Proposed Uniform Contract Code, *31 St. Mary's Law Journal*, 7, 7–17 (1999).

[45] Note that consideration is not required in making a contract in China. Therefore, a mutual assent through offer and acceptance needs not be supported by consideration in order for a contract to be valid.

intention to make a contract with others, and its contents must be definite and certain with an indication that the offeror will be bound upon acceptance. Article 15 classifies as an invitation for offer the price quotation forms, auction notice, public notice for bids, prospectuses as well as commercial advertisements. Acceptance is defined in Article 21 as the manifestation of offeree's assent to an offer.

Second, the Contract Law attempts to be more market-economy oriented than previous contract legislation that bore the marks of planned economy. China used to be a country of centrally planned economy where the government plans played decisive role in the nation's economy. After its opening up to the outside world, China has made dramatic efforts in transforming from a panned economy to a market economy. Therefore, the Contract Law seems to diminish the idea that contracts are the vehicle of carrying on the state economic plan and the contracting parties are mandated to implement the state economic plan through the contracts.

On the other hand, however, the Contract Law remains to contain provisions of state-plan-related contract. An example is Article 38. It provides that the relevant legal persons or other organizations shall enter into contracts between them in accordance with their rights and obligations as stipulated by relevant laws and administrative regulations when the State issues a mandatory task or a State purchasing order upon necessity. Taken literally, application of Article 38 would have three limitations: (1) it only applies to legal persons or other organizations, not natural person; (2) the legal persons or other organizations must be those who are affected by the State task or purchasing order; and (3) the State task must be mandatory and the purchasing order must be made by the State.

Third, the Contract Law adopts provisions from international treaties or conventions in an effort to be in compliance with China's treaty obligations and to be in line with the internationally accepted practices. For instance, Articles 17 (Withdrawal of Offer), 18 (Revocation of Offer), and 31 (Acceptance with Additional or Modified Terms) of the Contract Law are correspondingly in consistence with Articles 15 (b), 16 (a), and 19 (a)(b) of 1980 UN Convention on Contracts for the International Sale of Goods (CISG), to which China became a member in December 1986.

In addition, under Article 11 of the Contract Law, the written forms of contracts are referred to the forms that can display the described contents visibly, such as written contractual agreement, letters and electronic data text (including telegram, telex, fax, EDI and E-mails). This provision is basically originated from the 1996 E-Commerce Model Law of United Nations Commission on International Trade Law (UNCITRAL). More over, Chapter 9 (Contract for Sales) of the Contract Law is primarily rested on CISG as well as UNIDROIT Principles of International Commercial Contracts.

6. Adoption of the Ideology of "Governing the Country by Law"

The contract law legislation, though not systematically complete yet, may serve as an indicator that China has been making efforts trying to establish a rule-based regime for the civil matters. In fact, since early 1990s, there has been an increasing advocacy for construction of legal infrastructure in the nation, and the purpose of which is to promote the idea that the country shall be governed by law. From the viewpoint of the west, what lacks in China generally is the "rule of law" – a commonly used but poorly defined phrase in the west.[46] From Chinese point of view, however, the preliminary stage for the rule of law is to have the laws, and China now is in that stage.[47]

Despite that the concept of the rule of law may differ between the east and the west, in China it normally refers to as "governing the country by law". It is also the rhetoric that the modern Chinese leaders commonly use to differentiate themselves from the past, the Mao era in particular, when the country was actually ruled by men. There are four basic elements that are commonly defined in China as the core for a rule-based system, and the elements are: (1) there must be laws to follow, (2) laws must be observed, (3) enforcement of laws must be strict, and (4) violation of laws must be dealt with.[48]

In order to manifest the commitment of the Chinese government to the ideology of "governing the country by law", the Constitution of China (1982) was then amended on March 15, 1999. In the 1999 Amendment, article 5 of the Constitution (1982) is changed to include the following sentence: " The People's Republic of China is committed to governing the country according to law and building the socialist country ruled by law."[49] No matter how the language used here is to be interpreted, this Constitutional article is acclaimed in China to be the base on which the future Chinese legal system stands.[50]

Logically, therefore, to the extent that the country is to be ruled by law, the law of contract would play a vital role in regulating the civil affairs in the

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[46] See Barry M. Hager, *the Rule of Law: Defining it and Defending it in the Asian Context*, the Rule of Law, Perspectives from the Pacific Rim published by the Mansfield Center for Pacific Affairs 1–10 (2000).

[47] See Xin Chunying, *supra note* 4 at pp. 338–353.

[48] See also Albert H.Y. Chen, *Toward A Legal Enlightenment: Discussion in Contemporary China on the Rule of Law*, the Rule of Law, Perspectives from the Pacific Rim published by the Mansfield Center for Pacific Affairs 13–14 (2000).

[49] See Article 5 of the Chinese Constitution (as amended 1999), the Constitution of the People's Republic of China, (Law Press, 2000).

[50] See Yin Xiaohu, see *supra* note 11, at pp. 281–284.

nation. In a more general sense, the two-decade long reform in China has made the country reach the point where all major laws are well in place. What is critical, however, is not what laws the country has, but whether the laws adopted would be strictly observed and effectively enforced. Needless to say, this is the greatest challenge that now faces China.

7. Unsolved Issue: Judicial Independence

A fundamental issue concerning Chinese judicial system is the judicial independence. Chinese courts in general are regarded as being lack of independence, which has vitally threatened the judicial justice. Confronted with the growing criticism from the public, the Supreme People's Court since 1999 has made it the main work theme of the courts to build "justice and efficiency".[51] Despite the fact that there has been an increasingly strong voice calling for independent judicial system, the people's courts seem to still encounter insurmountable hurdles in exercising their judicial power independently.

Indeed, it is fair to say that judicial independence is a recognized principle in the Chinese Constitution and laws. Take a look at the Chinese Constitution. In 1954 when the first Constitution was adopted, it was provided that the people's courts shall adjudicate cases independently and abide only by laws.[52] Article 126 of the current Constitution, adopted in 1982, further provides that the people's courts shall exercise the judicial power independently according to stipulations of laws, free of any interference by administrative agencies, social organizations or individuals.[53] This constitutional provision is also embodied in 1979 Organic Law of the People's Courts (as amended 1983),[54] and 1995 Law of Judges (as amended 2001).[55]

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[51] *See* Supreme Court President Xiao Yang, Working Report of the Supreme People's Court to the First Session of the 10th National People's Congress, March 11, 2003. The full text of the report is available at http://www.court.gov.cn/work/200303280001.htm.

[52] *See* the Constitution of the People's Republic of China 1954.

[53] *See* the Constitution of the People's Republic of China 1982. English translation is available at http://www.qis.net/chinalaw/lawtran1.htm.

[54] Article 4 of the Organic Law of the People's Courts (as amended 1983) is exactly a copy of Article 126 of 1982 Constitution.

[55] The Law of Judges of China was adopted on February 28, 1995 and amended on June 30, 2001. In Article 1 of the Law (as amended), it states that purpose of this Law is to safeguard the independent exercise by the people's courts of judicial power and judicial justice. Article 8 provides that a people's court judge shall have the right to adjudicate cases independently without interference by administrative agencies, social organizations and individuals.

Therefore, literally speaking, the people's courts are granted an independent judicial power under the Chinese Constitution and laws. The problem, however, is that the judicial power may not be exercised independently. Even for the Supreme People's Court, its activities are not completely free of interference. On this matter, there is nothing wrong with the laws, but there is something that actually cripples the judicial independence. The cause is the inherent defects that exist in the current judicial system. China is a communist-party-dominated socialist country and the separation of powers is not the main theme of the nation. The political system of China is the system of people's congress and this is also the basically organizational form of the nation's political power.[56] According to the Constitution 1982, the National People's Congress (NPC) is the highest body of the state power.[57] But this highest body is required to be under the leadership of the communist party.[58] The Supreme People's Court, though defined as the nation's top judiciary body, is required to report to the NPC.[59] Under the NPC, there are local people's congresses at the level of provinces and counties to which the lower people's courts at corresponding level are responsible.[60]

The current organizational structure of the judicial system has an obvious system defect, which makes the judicial independent extremely difficult. As noted, China maintains a unitary judicial system with four levels from the Supreme People's Court down to the county trial courts. But the Supreme People's Court has no control over any of the lower courts except for work connections. All judges at the lower people's court are selected and appointed by local people's congress that is heavily influenced by local communist party chief and government heads. More importantly, the operation expenses including salaries of the judge are provided locally from the local government budget. In addition, judges in China do not have a statutory term, and they could be replaced or removed anytime by their corresponding people's congress at will. It is therefore quite common that judges at a local people's court would have to follow the "instructions" or "opinions" from local government on particular cases. Also, it has been a long tradition in Chinese history that government power and judicial power are always intertwined.[61]

A recent case that was tried at Luo Yang Intermediate People's Court of He Nan Province may serve as an excellent example to help illustrate the current

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[56] *See generally* Xu Congde, *supra* note 9 at pp. 102–136.

[57] *See* Chinese Constitution (1982), art. 57.

[58] *See* Xu Congde, *supra* note 9 at pp. 117–118.

[59] *See supra* note 51, art. 128.

[60] *See id*.

[61] For thousand years in the Chinese history, judicial power was rested with executive branch. Thus, a mayor was not only the administrative head but also the chief judge.

fate of judicial independence in China. The case, named as *Ru Yang County Seeds Co. v. Yi Cun Seeds Co*. (known as Luo Yang case), involved a dispute over the contract to provide parent corn seeds. What is significant, however, is not the case itself but the court decision with regard to the application of local regulation that is inconsistent with the State Seeds Law. For purposes of discussion, the full text of the court decision is translated as follows:

Luo Yang Intermediate People's Court of He Nan Province
Civil Judgment Document

Ru Yang County Seeds Co. v. Yi Cun Seeds Co.

(2003) Luo Min Chu Zhi No. 6

Plaintiff: Ru Yang County Seeds Co.
Official Representative: Cui Hao Xian, Manager of Plaintiff
Legal Counsel: Chen Zhan Jun, Attorney from Luo Yang Ju Xing He Law Firm

Defendant: Yi Cun County Seeds Co.
Official Representative: Zhang Xia Lei, Manage of Defendant
Legal Counsel: Wang Xiang Ru, Attorney from Luo Yang Da Xin Law Firm
Agent *ad litem*: Song Yan Jun, Head of Commodity Pricing Division of Commodity Pricing Bureau of Yi Cun County

This case was filed by Plaintiff Ru Yang County Seeds Co. (hereinafter referred to as Ru Yang Co.) to sue defendant Yi Cuan County Seeds Co. (hereinafter referred to as Yi Cuan Co.) for the dispute involving a contract on entrusted reproduction of corn seeds. After taking the case, this Court has formed a collegial panel according to the law and the penal has held open court hearings, attended by Chen Zhan Jun, Legal Counsel for plaintiff, and Zhang Xia Lei, Official Representative of defendant, Wang Xiang Ru, Legal Counsel and Song Yan Jun, Agent *ad litem* for defendant. The court hearings now have come to an end.

Plaintiff Yu Yang Co. claimed that on May 22, 2001, plaintiff entered into a "Contract on Entrusted Reproduction of Corn Seeds" with defendant. Under the contract, plaintiff agreed to provide defendant with 4,857 *jin* of parent corn seeds (1 Chinese *jin* is equivalent to 0.5 kg, note added) and defendant agreed to use them to reproduce 200,000 *jin* of hybrid corn seeds specified as Nong Da 108 with a quality matching the national standard of second grade or above. The term for the reproduction expired on October 31, 2002. The contract also contained explicit provisions with regard to other rights and obligations of the parties.

Plaintiff asserted that during the course of actual performance of the contract, defendant failed to fulfill its obligations and did not deliver to plaintiff any hybrid corn seeds reproduced. As a result, on the basis of market profit margin between RMB 3.4 to 3.9 Yuan per *jin*, plaintiff has suffered a loss of expectation interest for about RMB 680,000 to 780,000 Yuan, and plus other economic damages, the total actual loss was around RMB 1,000,000 Yuan. After several unsuccessful negotiations, plaintiff brought this lawsuit, and asked the court to order: (1) defendant pay plaintiff RMB 1,000,000 for contract damages and other economic loss, and (2) defendant bear all litigation costs. During the court hearings, plaintiff modified its claims to request instead to recover from defendant (1) RMB 12,185 for the cost of parent seeds, and (2) RMB 703,784.60 for contractual damages.

Defendant argued that its failure to perform the contract was caused by the significant drop in production resulting from the severe drought, and plaintiff should also bear certain liability for breach of contract because during the production and processing of the seeds plaintiff did not conduct any on-site inspection nor did plaintiff participate in any seeds purchasing. Defendant further argued that the "Regulations for Administration of Crop Seeds of He Nan Province" explicitly provided that purchasing and selling of seeds must strictly follow the provincial policy of unified pricing, and that the "Notice of Methods for Administration of Major Crop Seeds" jointly issued by the Commodity Pricing Bureau of He Nan Province and the Bureau of Agriculture of He Nan Province clearly provided a formula for calculating the selling price of seeds. Defendant contended that under the formula, the overall profit rate for the hybrid seeds shall be within 23% margin, and the net profit should be between 8% and 10%, and therefore even if Yi Cuan Co. had fully performed the contract, plaintiff's retainable interest should be within RMB 16,800 and 25,000 Yuan.

During the hearings, the Court found that:

Plaintiff and Defendant entered into the "Contract on Entrusted Reproduction of Corn Seeds" on May 22, 2001. Under the contract, plaintiff would at its own cost purchase 4,875 *jin* of Nong Da 108 hybrid corn seeds, and entrust defendant to reproduce 650 *mu* (about 97 acres, note added) with a total output of 200,000 *jin* hybrid cord seeds and a quality standard of the State Second Grade or above. The period for performance of the contract would end October 30, 2002. After receiving the produced hybrid corn seeds, plaintiff would pay defendant a seeds reproduction fee at RMB 0.2 Yuan per *jin* (including the expenses of reproduction management, purchasing, shelling, short-distance transportation to plaintiff's processing factory, and other expenses). The price for plaintiff to accept the seeds (the contract price, note added) would be the base-purchasing price plus reproduction fee and the base-purchasing price would be calculated at 2.2 to 2.5 times as much as local corn seeds market price at the time of purchasing. Plaintiff's expenses for purchasing the parent seeds would be off set from the contract price when it receives the reproduced seeds.

According to the contract, Defendant would be responsible for the reproduction management, technical instruction, purchasing and shelling, and transporting of the seeds to plaintiff's processing factory. During the course of reproduction, plaintiff would visit the site for 3 to 4 times. When purchasing the reproduced seeds, plaintiff would send one person to participate in examining the quality of the seeds. The total weight of the reproduced seeds received by plaintiff would be the net weight after a deduction of the water content of the seeds at the ratio of 3–5% of gross weight. It was provided in the contract that plaintiff would unconditionally accept all reproduced seeds provided by defendant while defendant would unconditionally provide plaintiff with total output of the reproduced seeds regardless of the corn seeds market situation.

On the day of the contract, plaintiff provided defendant with 3,899 *Jin* of Nong Da 108 maternal corn seeds and 975 *jin* of paternal corn seeds at a cost of RMB 12,185 Yuan. Defendant then under the contract planted these seeds into 650 *Mu* of the seed reproduction base. As of today after the harvest of the seeds, defendant did not make any delivery of the reproduced corn seeds of Nong Da 108 to plaintiff.

The Court further found that:

1. The accounting vouchers of defendant from May 1, 2002 to June 30, 2002 revealed that during the same period of time, the price dependant used to purchase Nong Da 108 corn seeds from farmers at the reproduction base was RMB 2.904 Yuan/kg. The "Monitoring Report of Yi Cuan County of Luo Yang Municipality on the Standard of Price and Fees for Major Agricultural Products" also showed that the medium

corn market price at Yi Cuan County in October 2001 was RMB 1.00 Yuan/kg. In the meantime, defendant's accounting vouchers during April 1, 2002 and June 30, 2002 indicated that the wholesale price for the coated corn seeds of Nong Da 108 was RMB 10.60 Yuan/kg, and the wholesale price of the bare corn seeds was 10.00/kg. For the same period, the wholesale price for coated and bare corn seeds at each of retail stations of Ru Yang County was the same as that of Yi Cuan County.

2. The accounting records of Yi Cuan County (from May 1, 2002 to June 30, 2002) evidenced that the cost of the corn seeds sun-drying was RMB 8 Yuan/ton, cost of turnover for shelling was RMB 8 Yuan/ ton, labeling fee was RMB 5.253 Yuan/ton, packaging fee RMB 30 Yuan/ton, and unloading fee RMB 3.5/ton. On this basis, the processing cost for the corn seeds was RMB 0.062154 Yuan/kg. Plaintiff agreed to computer this cost into the price of the reproduced corn seeds.
3. Defendant Ru Yang Co. was exempted from paying Business Income Tax and Value Added Tax for the year 2002 under the State Policy.
4. The "Regulations for Administration of Crop Seeds of He Nan Province" (Provisional) took effect on Aril 27, 1884, and its successor "Regulations for Administration of Crop Seeds of He Nan Province" was effective on November 8, 1989, which was amended again on October 22, 1993. Article 36 of the Regulations provides:

> "the purchase and sale of seeds shall strictly comply with the provincial policy of unified price, and no price may be raised without authorization. With regard to the seeds for which there is no provincially unified price, the price shall be determined jointly by the city (district) or county administrative department of agriculture and department of pricing."

On August 20, 1998, He Nan Provincial Bureau of Commodity Pricing and Provincial Bureau of Agriculture together issued the "Yu Jia Nong Zhi (1998) No. 188 Document", namely the "Notice of Methods for Administration of Major Crop Seeds" (Notice). The first paragraph of the Notice required that the method for price administration of major crop seeds be the government guiding price, and the principle of the price management be that of "unified leadership and level-by-level management". Under the Notice, the calculating formula for the sale price of seeds is set as "sale price = (cost of purchase + seed-selecting process fee) × (1 + rate of composite deviation) + tax". On July 8, 2000, "the Seeds Law of the People's Republic of China" was adopted, and it went to effect December 1, 2000, which repealed the "Regulation of Seeds Administration of the People's Republic of China" promulgated by the State Council on March 13, 1989.

The Seeds Law is silent about the price of purchase and sale of seeds, and in addition, the price category made by the State Commission of Planning and other relevant departments of the State Council does not make the price of corn seeds the State fixed price or State guiding price. More over, there is no provincial price category in He Nan. Therefore, the price of goods and services that are not listed in the price category at both State and provincial levels shall be determined by market.

5. The Book "Fine Seeds of Crops in China" tells that Nong Da 108 corn seeds will produce about 600 kg corns per *mu* if planted in Spring, or around 500 kg/*mu* if planted in Summer. The "Yearbook of Luo Yang Statistics" indicates that in 2001 the production output of corns per *mu* was about 208 kg.

It is therefore held that:

The contract entered by and between plaintiff and defendant is a valid contract because it is a manifestation of the true intent of the parties, and its contents do not violate any

prohibitive provisions of law or regulation. Once the contract is established, the parties shall fulfill their each contractual obligation conscientiously. In the case at bench, after plaintiff provided defendant with the parent corn seeds under requirement of contract, defendant failed to deliver to plaintiff the corn seeds with agreed quantity and quality in accordance with the contract. Such failure constitutes a breach of contract, for which defendant shall be held liable. According to the "Yearbook of Luo Yang Statistics", the production output of corns per *mu* was about 208 kg in 2001, which was lower than the average output during the past years. In addition, the drought situation in the three-month period of May, June and July 2001 can be proved from the meteorological records provided by the Meteorology Bureau of Yu Cuan County. Therefore, the agreed output of corn seeds per *mu* by the parties should be reduced accordingly by 10%, and defendant's argument in this regard is sustained.

With regard to agreed 3–4 times onsite inspection by plaintiff, it shall be regarded as plaintiff's right, of which plaintiff shall be free to choose not to exercise. Thus, plaintiff's choice to give up the inspection right does not constitute a breach of contract, and defendant's assertion must be denied. After the Seeds Law took effect, the corn price is to be determined on the basis of the market situation. **Since the "Regulations for Administration of Crop Seeds of He Nan Province" is a local law subordinate to national law in terms of legal effect, any of its provisions that is in conflict with the Seeds Law shall necessarily be void. Furthermore, the "Notice" of He Nan Provincial Bureau of Commodity Pricing and Provincial Bureau of Agriculture was issued under the "Regulations", and the any provision contained in the "Notice" that is inconsistent with the Seeds Law must also be void** (emphasis added). Consequently, defendant's argument about using the formula provided in the "Notice" to calculate the actual loss of plaintiff's expected interest has no legal ground, and should not be supported by the Court.

The Court concludes that because defendant never delivered to plaintiff any reproduced corn seeds under the contract, defendant shall pay plaintiff for the cost of RMB 12,285 Yuan for the purchased parent corns seeds, and defendant shall also be liable for the loss of plaintiff's expected interest on the ground of breach of contract. Therefore, in accordance with Article 4 of General Principles of Civil Law of People's Republic of China, and Articles 109, 112, 113 and 118 of Contract Law of the People's Republic of China, it is so ordered:

1. Defendant, within 10 days after this judgment becomes effective, pay plaintiff for the cost of parent corns seeds in the amount of RMB 12,185 Yuan;
2. Defendant, within 10 days after this judgment becomes effective, pay plaintiff for its economic loss in the amount of RMB 597,001 Yuan;
3. Plaintiff's other claims be dismissed.

The cost for hearing the case is RMB 12,170 Yuan, property attachment cost RMB 3,520 Yuan, and other costs RMB 2,434 Yuan. Of these three items with a total cost of RMB 18,124 Yuan, defendant shall bear RMB 16,500 Yuan, and plaintiff RMB 1,624 Yuan.

If any party disagrees with this judgment, it may appeal to the High People's Court of Henan Province within 15 days after being served with this judgment by handing over to this Court the petition for appeal with copies of the appeal to the other party according to the number of participants.

Head Judge:	Li Hui Juan
Judge:	Zai Tao
Acting Judge:	Zhu Meng (Sealed)
	May 27, 2003
Clerk:	Zhang Yan Jun

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Apparently, this judgment, though not an ideal one, is among the fine judgments that are clearly written with some analytical reasoning. The most beautiful part of this judgment is the challenge that the judge made to the local regulations conflicting with the State Seeds Law (national law). In reaching the conclusion, the trial judge examined the local regulations in light of the national law, and made rational efforts to preserve the authority of the national law. Such efforts in every respect are with the four corners of the Legislation Law of China. Article 79 of the Legislation Law explicitly provides that the legal authority of State law is higher than that of local law and regulations,[62] which is interpreted to mean that any existing local law or regulation that contradicts the lately enacted national law shall be void. In addition, under the Judge Law of China, judges are required to faithfully implement the Constitution and laws and it is the obligation of the judges to strictly observe the Constitution and laws.[63]

Unfortunately, however, when the judgment was handed down, it was immediately read as something offensive to the local government. The judge's opinion concerning the application of the Seeds Law over local regulations was blamed as an intrusion into local government power and even more seriously a violation of Chinese people's congress system. On October 13, 2003, both the Office and Legal System Division of the Standing Committee of the People's Congress of Henan Province issued a flamingly worded notice condemning the judgment and urged the High People's Court of Henan to vigorously look into and handle this "serious matter".[64]

On October 21, 2003, the High People's Court circulated a Notice of Criticism among its court system characterizing the judgment as a law-breaking conduct of the court that has threaten the authority of local law and regulation as well as the unified legal system. Ironically, when warning that if the same incident ever happens again, the judge and its direct superior both will be seriously held liable, the High People's Court of Henan unequivocally stated that to prevent this incident from reemerging was an essential means to maintain "judicial justice and efficiency".[65]

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[62] Adopted on March 15, 2000, the Legislation Law of China regulates the enactment, amendment and repeal of laws, administrative regulations, local laws and regulations, regulations of autonomy region and specific regulation.

[63] See art. 3 and 7 of the Judge Law, *supra* note 55.

[64] See the Official Document of the Office of the Standing Committee of the People's Congress of Henan Province, Yu Fa Chang Ban (2003) No. 78, and Official Document of Legal System Division of the Standing Committee of the People's Congress of Henan Province, Yu Ren Chang Fa (2003) No. 18.

[65] See Official Notice of the High People's Court of Henan Province,Yu Gao Fa (2003) No. 187.

Under the tremendous pressure from the local government, Luo Yang Intermediate People's Court issued a self-criticism notice internally on October 28, 2003 directly blaming Judge Li Hui Juan and her supervisor, deputy chief judge of the first civil division of the court for their failure to duly perform their duties as judges. In its notice, the court stated that during the trial the people's court may only apply the law and has no authority to question the validity of local law and regulations. Considering this is a serious political matter, the court further stresses that no judgment shall ever contain anything that would render the local law and regulation void.[66] Consequently, Judge Li Hui Juan's employment with the court was suspended for months and although her employment was later reinstated, clearly this incident may negatively affect her promotion in the court or even her career as a judge.

It is without doubt that the Luo Yang case set a very illustratable example about how the judges might be treated in China when they are tying to be independent. Of course, there has been great sympathy for Judge Li in Chinese legal community and many openly offer strong support to Judge Li and her decision not to apply the local law and regulations that contradict the national law. Indeed, the issue whether the people's court may question the validity of local law and regulations is clearly debatable under the Chinese Constitution, particularly when there is an obvious conflict between the national law and the local law. As a matter of fact, in early 1993, the Supreme People's Court had made attempt in this regard. On March 11, 1993, in its "Answer to the High People's Court of Fu Jian Province Concerning Application of Law When There Is a Conflict Between National Administrative Law And Local Law", the Supreme People's Court made it clear that when hearing administrative case, if local law and regulation were inconsistent with (national) law and administrative regulations, the latter shall be applied. According to the Supreme People's Court, this Answer was made after consulting with the Standing Committee of the National People's Congress.[67]

Applying the Supreme People's Court's "Answer" to the Luo Yang case, there was nothing wrong with Judge Li's refusal to apply the local law. But the spark that caused the fire seemed to be Judge Li's opinion on the validity of the local law – intolerable because it was deemed to have broken an unalterable rule: "You may not apply the local law in this case but you should not say so". This would necessarily raise many legitimate questions that deserve

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[66] See Official Notice of Luo Yang Intermediate People's Court, Luo Zhong Fa (2003) No. 147.

[67] See Supreme People's Court, "Answer to the High People's Court of Fujian Province on the Question Which Law Shall Be Applied When in Administrative Cases the Provisions of Local Law and Regulations Were Inconsistent with the Law and Regulations" on March 11, 1993. Fa Han (1993) No. 16.

serious discussions. These questions include: (1) what law should the judges preserve and follow – national law or local law? (2) what would the "unified legal system" really mean? (3) what would the judicial power be under the Constitution? (4) should a judge be held liable for his or her judgment? (5) what would be the real relationship between national law and local law? (6) would the legislative body have the power to interfere with judicial matters?[68] The outcome of Luo Yang case could also best explain why in Chinese courts many judges are reluctant to offer detailed reasons for their decisions – because there are so many minefields lying ahead.

Interestingly, the trial court decision of the Lou Yang case was appealed by both plaintiff and defendant to the High People's Court of He Nan Province. In its decision entered on May 9, 2004, the High People's Court affirmed the trial court's opinion concerning the legal effect of the National Seeds Law over the local regulations in question. The High People's Court held that the since the contract in the instant case was concluded on May 22, 2001, its validity must be viewed in the light of the Contract Law and related judicial interpretations, and on this ground, the validity of this contract should be determined according to Article 52 (5) of the Contract Law and Article 4 of the Supreme People's Court "Explanations to the Questions concerning Application of the Contract Law of the People's Republic of China". Under Article 52 (5), a contract is null and void if it violates the mandatory provisions of law and regulations. As required by Article 4, after the Contract Law took effect, the people's court, when determining the voidance of a contract, shall apply the law passed the National People's Congress and regulations adopted by the State Council, but not local rules or regulations.

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[68] In Nov. 2003, a roundtable discussion on Luo Yang case was held at Tsinghua University School of Law in Beijing. Attended by a number of constitutional law scholars, lawyers and judges, the discussion dealt with several interesting questions arising from the Luo Yang case and some of them seemed both controversial and sensitive: **Constitutional Question**: (a) The relationship between legislation and judiciary – who deals with what? (b) Review of law and constitutionality – should the people court have sort of judicial review power? (c) Division between national legislative power and local one, and between central government authority and local one – how should such powers be divided? (d) Judicial effect of constitutionally legal question – what judicial effect should the Legislation Law have? (e) Understanding of unified legal system – who has the obligation to maintain the unified legal system? **Judicial Question**: (a) Are the judges the State judges or local judges and what should the judges protect? (b) Should there be legal reasoning in the court judgment, and how should such legal reasoning be written? (c) Is judicial independence the independence of court or independence of judge, and should the "trial committee" be abolished? (d) Relationship between a higher people's court and its lower people's courts – should the High People's Court be responsible for the conducts of its lower people's courts?

The High People's Court upheld that trial court decision by stating that the trial court judgment should be affirmed because the facts on which the judgment entered are clearly ascertained, and the application of law is correct and there is no improper handling of the substance of the case. In the meantime, however, the High Court in particular pointed out that in the legal reasoning in support of its decision, the trial court inappropriately state that after the adoption of the Seeds Law, the price of the corn seeds is to be determined by the market, and the Regulations for Administration of Crop Seeds of He Nan Province" is a local law subordinate to national law in terms of legal effect, any of its provisions that is in conflict with the Seeds Law shall necessarily be void. The High Court then held that such a statement has to be corrected.[69]

This book is not intended to explore the answers to the questions about judicial independence in China, and it also should not be expected that the answers could be easily found. As it has been emphasized, China is the country where the courts must be positioned under the communist party's absolution leadership for which there is lack of effective check and balance, and only on this basis may the judicial power be exercised independently. Of course, people may have different views about what the judicial independence would exactly mean. But given the reality in China, it is not difficult to understand why the Luo Yang case could happen in such a unique way. The bottom line is that no matter what solutions may come up with regard to the questions above, the road toward judicial independence in China is still considerably long.

[69] See Civil Judgment of the High People's Court of He Nan Province, (2003) Yu Fa Min 2 Zhong Zhi No. 153.

Chapter I
Contract Law in Chinese Tradition

Once again, the most known term equivalent to contract in China is *Qi Yue* (commonly translated as "agreement"). Interestingly, according to some Chinese legal history scholars, the term "contract" (*He Tong*) actually appeared in ancient China 2000 years ago, but was soon replaced by the term *Qi Yue*. At that time, contract was regarded as a form of *Qi Yue*, and therefore, contract itself was not a *Qi Yue* rather it was used as a mark or symbol evidencing the existence of the *Qi Yue* between the parties.[1] In this sense therefore, "contract" was once translated in Chinese as *Qi Ju* – certificate or written record of *Qi Yue*.

In modern China, the term "contract" was not commonly used until late 1970's when western literatures on contract were gradually introduced into the nation. For many years before that, the term "contract", when used, was always associated with the term *Qi Yue* and was phrased as *He Tong Qi Yue* (contractual agreement). Scholars in China had debated on the difference between *He Tong* (contract) and *Qi Yue* (agreement),[2] but most now believe that it would have no any practical significance to differentiate them.[3]

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[1] See He Weifang, *Analytical Differentiation between "Contract" and "Agreement"*, 2 Jurisprudence Research (1992).

[2] Some scholar argued that contract refers to the meeting of minds in the same direction between the parties involved while the agreement means the declaration of wills between the parties, which would include a meeting of the minds not necessarily in the same direction. See Zhou Linbing, *Comparative Contract Law*, 80–81 (Lanzhou University Press, 1989).

[3] See Wang Liming, *Contract Law*, *Fundamentals and Case Analysis,* 7 (People's University Publishing House, 2001).

What seems important in understanding Chinese contract law is the concept of *obligatio* (also translated as obligations). As noted, bearing Roman law tradition, the *obligatio* represented a particular legal relationship where one person is obligated to the other either because of contractual obligation or other legal acts or under the provisions of law such as torts or unjust enrichment. Unlike the term "obligation" in the common law sense, the *obligatio* contains both legal rights where the obligee (creditor) has valid claim against obligor (debtor) and obligations where the obligor (debtor) is liable for what he owes to the obligee (creditor).[4] Based on this notion, when the term *obligatio* is used in the Civil Code, it is defined to refer to the specified relationship of rights and obligations between the parties concerned.[5]

1. Concept of Contract

Although the concept of *Qi Yue* (agreement) was used in China for many centuries, it was never clearly defined.[6] In the meantime, the term *obligatio* (not in its modern sense) was used interchangeably to mean contractual obligation, and it was mostly referred to monetary obligation under which the debtor was responsible for paying the creditor.[7] A *Qi Yue* (agreement), once made, commonly implied a legal relationship under which an obligation was created.[8]

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[4] See *id.* at pp. 13–14.

[5] Under Article 84 of the 1986 Civil Code, *obligatio* is a specified relationship of rights of obligation created by the contractual agreement or provisions of law between the parties, where the party enjoying the rights is the obligee and the party bearing obligations is obligor, and the obligee is entitled to ask the obligor to perform according the contract or the provisions of law. An English translation of the Civil Code is available at http://www.qis.net/chinalaw/prclaw27.htm. This definition however was criticized as being incomplete because certain legal acts other than making a contract may also cause the *obligatio* to be created, e.g. the reward advertisement which is a unilateral act. Therefore, some suggest to define the *obligatio* as the relationship of rights and obligations under which specified performance is requested between the specified parties arising from legal acts or the direct provisions of law. See Wang Liming, *the Proposed Draft of the Civil Code of China and Legislative Reasons – Contracts*, 12 (Law Press, 2004).

[6] During 1955 and 1956, the drafters of the proposed civil code once tried to define Qi Yue as "an agreement made between two or more people in order to create, modify or terminate the obligatio relation of right and liability". In the meantime, however, many suggested not to have this definition included in the draft. See He Qinghua, et al, *An Overview of Civil Code Drafts of New China*, Volume I, 175 (Law Press, 2003).

[7] See Wang Jiafu, *Civil Law Obligatio*, 16 (Law Press, 1991).

[8] See Zhang Jifan, *Evolution of the Chinese Legal Civilization*, 287 (China University of Political Science and Law Press, 1999).

1.1. Confucianism Tradition

The law of contract in ancient China took the form of rules of *Qi Yue* (agreement), which governed the substance of *Qi Yue*, its making-process and enforcement. In more than 2000 years of Chinese history, the rules of *Qi Yue*, though different from dynasty to dynasty, had three characteristics in common. First of all, most of the rules in their formality were customs or common usages complied as norms. Secondly, the rules were patriarchal in nature and focused primarily on obligations without specifying rights. The idea was that in any of the dynasties, the whole country was like a family where the emperor who was deemed as the son of heaven was the head of the family and everyone else was the family member subject to the absolute control of the emperor.[9] Thirdly, the punishment for breach of agreement or violation of obligation was harsh, and mostly was punitive as provided in the penal law.[10]

In a broader sense, one of the major distinctions in the traditional Chinese legal system is that the laws or rules were structured on a comprehensive and monolithic model where both civil and criminal rules were combined together.[11] Although there is an ongoing debate among Chinese scholars on whether civil law and criminal law were distinguishable in the traditional Chinese legal system,[12] the commonly accepted notion is that the criminal law served as the backbone of the entire legal system.[13] For that reason, in Chinese legal history, the word "law" was normally interpreted to mean "penalty" or "punishment" (*Xing*).[14]

With regard to the enforcement of contractual obligation, it relied more on moral standards than on legal requirements. In other words, the contractual obligation was enforceable because the parties to the agreement were morally bound by what they had promised to each other. A common phenomenon in the Chinese legal history was that the law was to a great extent interwoven with the philosophy of Confucianism as well as the feudal ethic rules.[15] What the Confucian philosophers advocated strongly was moral means and virtues.

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[9] See Wang Chengguang, *An Emerging Legal System*, a chapter in Zhang Xianchu, "*Introduction to Chinese Law*", 4–8 (Sweet & Maxwell Asia, 1997).

[10] See Wang Jiafu, supra note 7 at p. 17.

[11] See Wang Chengguang, *supra note* 9 at p. 5.

[12] In general, the traditional Chinese legal system in 2000 years of Chinese history as characterized as "combination of all kinds of laws into one scheme and no separation between civil and criminal laws." The criticism is that the general notion was misleading and the traditional Chinese legal system should in fact be addressed as "coexistence of all laws and differentiation of civil law from criminal one." See Zhang Jinfan, *supra* note 7 at pp. 7–8.

[13] See Wang Chengguang, *supra* note 9 at 6.

[14] See Xin Chuying, *Chinese Legal System and Current Legal Reform*, 313 (Law Press, 1999).

[15] See Wang Chengguang, *supra* note 9 at 7.

One of the virtues was about promise honoring. Under the doctrine of Confucianism, "a promise, once made, shall worth thousand ounces of gold". Therefore, a violation of agreement would be deemed as a violation of virtue and moral standard, for which a punishment shall be imposed.[16]

1.2. Civil Law Influence

The modern Chinese legal system is strongly marked with the civil law tradition. Historically, China was a closed and self-sufficient country and the "Great China" used to be taken as the shining glory in many dynasties and little attention was ever paid to any of other countries in the world. Perhaps because of the indulgence in this glory, the emperors, though in different dynasty, were inured to living in the dream that they were the center of the world and whoever came to see them must show sincere respect on bended knees. But unfortunately, this glory did not fence off the breeze that blew into China from the west.

In the recent Chinese history, there were two times at which the nation opened the door to the outside world. The first time was 1840 when the Opium War brought foreign invaders into the Chinese territory, and the door of China was forced to open. The "extraterritoriality" established for western countries on the Chinese soil under the "unequal treaties" gave the foreign forces the opportunity to administer "western justice" in their respective "foreign port" or "sphere of influence" within China.[17] The second time was 1979 when China was driven by necessity to revive its economy, and the nation's door was opened to the west at it own initiative. The 1979 opening-door policy not only made China prosperous through the economic reform, but also helped China gain the membership in the WTO.

As early as in late *Qing* Dynasty (1644–1911), the influence from the west began to affect the nation. At that time, in order to find the "cure" to make the ailing country strong again, a call for reform in political and legal systems became appealing in the Forbidden City. Advocated by the reformers, Emperor *Guangxu* in 1902 issued an "Imperial Edict" ordering to revise and amend existing laws (the Great Qing Codes) through the means of taking foreign laws as guidance. For purposes of the reform, the Emperor appointed jurists *Shen Jiaben* and *Wu Tingfang* the commissioners of legal revision.[18]

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[16] See Wang Jiafu, *supra* note 7 at p. 17.

[17] See Jerome A. Cohen, *Forward* in "*The Rule of Law, Perspectives from the Pacific Rim*", Published by the Mansfield Center for Pacific Affairs (2000).

[18] See Wang Jiafu, *supra* note 7 at pp. 17–18. Also in 1904, Emperor Guangxu issued an edict to Prince Tsa Tchen, which stated: "the development of commercial relations, the encouragement to industry have always been the primary duty of the Government, and must be

Several years late, in 1907, the Office of Legal Revision was established and its main responsibilities were legal revision and law drafting. The Office of Legal Revision consisted of returned Chinese students studying abroad in Japan, Europe and US. A striking example demonstrating the reformers' efforts to "learn from the west" was that the Office of Legal Revision hired a Japanese jurist as advisor to help work on law drafting for the imperial government. In December 1910, the first draft of Civil Code was complete and it was finalized in 1911. However, the first draft did not become the law due to the fall of the *Qing* Dynasty in 1911.

The first draft of Civil Code contained five parts – general principles, rights of *obligatio*, property rights, domestic relations, and inheritance. Distinctively, the draft was primarily based on the German and Japanese law models and the first three parts were actually drafted by the Japanese jurist in the Office of Legal Revision.[19] Although the first draft never became the law, many of its provisions were used by the Nationalist Government after it was formed until 1925 when the second draft of Civil Code was made. The second draft essentially followed blueprint of the first draft and kept the civil law tradition unchanged. Part II of the second draft was named *Obligatio* which contained 4 chapters and 521 articles in total. Unfortunately, the second draft had the same fate as the first one and was never promulgated because of the political chaos.[20]

The first codified Law of *Obligatio* in China was adopted in 1930 as part of the Civil Code of the Republic of China (1930 Civil Code). The drafters of the 1930 Civil Code followed the 1925 draft and took into consideration the comments from members of the drafting committee and advisers. In addition to its German and Japanese origins, the 1930 Civil Code had a number of intakes from the codes in other major European countries such as France and Italy. As a combination of the essences of then existing civil statutes and the Chinese reality, the 1930 Civil Code had five parts that were entitled "General Principles", *Obligatio*, "Right of Things" (Property), "Family" and

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carefully attended to. We hereby order that Tsai Tchen, Yuan Chih Kai and Wu Ting Fang be commissioned to compile a commercial code which will constitute the rule to be observed in commercial transactions". See Joseph An-Pao Wang, China Studies, Studies in Chinese Government and Law, Civil Code of the Republic of China, x–xi (Kelly and Walsh, Ltd.) (1930), reprinted by University Publications of America, Inc. (1976).

[19] The Japanese jurist was Mr. Y.M. Matsuoka. See *id.* at p. 18. During that reform period, with an anxiousness to follow Japan's experience in emerging from the old feudalism into a modern country, hundreds of Chinese in search of new knowledge went to Japan to study and a significant number of them went to Japanese law schools. At that time, Japan had completed its civil and commercial codification, which was modeled primarily on the German codes. See Joseph En-pao Wang, *supra* note 18 at p. xi.

[20] See *id*. at p. 19.

"Successions".[21] Under the 1930 Civil Code, the sources that would cause *obligatio* to occur included *Qi Yue* (agreement), conferring of authority of agency, management of affairs without mandate (*negotiorum gestio*), unjust enrichment and torts.[22]

Interestingly, the five parts of the 1930 Civil Code took effect at different times. Part I was adopted on May 23, 1929, and was effective on October 10, 1929. Parts II and III were promulgated in November 1929 and came into force on May 30, 1930. Parts IV and V were enacted by the end of 1930.[23] Consistent with the Chinese tradition, the 1930 Civil Code still used the term *Qi Yue* (agreement) other than *Hetong* (contract). According to Article 153 of the 1930 Civil Code, "a *Qi Yue* (agreement) is made when the parties had reciprocally declared either expressly or tacitly their concording intention."[24] However, the 1930 Civil Code did not define the term *Qi Yue*, nor did it state the nature of the *Qi Yue* reached by the parties, i.e. the purpose that a *Qi Yue* would serve and the legal basis on which the *Qi Yue* would be enforced.

As noted, the 1930 Civil Code, along with other laws adopted by the Nationalist Government, was abandoned in 1949 by the Communist Government of China. The abandonment, however, did not change the civil law tradition of the Chinese legal system inherited from the decades-long influence of civil law literature. In addition, during 1950s, China was driven to establish its legal system on the model of former Soviet Union. Although the law in the era of Soviet Union was labeled as socialist law, it historically had a strong French influence,[25] which further embedded Chinese legal system in the civil law tradition.

A sharp difference between Chinese legal system and the legal system in common law countries is the legal authority of precedent. In common law countries, courts decisions are the major legal sources and the precedent could be used as the legal ground on which the court judgments stand. In China, the black letter rule dominates every corner of the legal proceedings, and statutes are the primary legal authoritative sources. Take contract law for example, in the United States, contract law is basically common law, embodied in court decisions, while in China contract law is the statute adopted by its national legislative body.

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[21] In Joseph An-Pao Wang's book, the obligatio was translated as "obligations" and "property rights" as "rights over things."

[22] See *id*. at pp. 45–57. Note that the term "unjust enrichment" was translated as "undue enrichment", and "torts" as "wrongful acts".

[23] See *id.* at pp. xiv–xv.

[24] See the 1930 Civil Code (English Translation), *id.* at p. 45.

[25] For general information, see John Henry Merryman, *The Civil Law Tradition* (2nd Ed, Stanford University Press, 1985).

Another difference is the way the law is drafted. In China, the law usually takes a formality of two parts: general provisions and specific provisions. The general provisions contain the purpose and scope of the law, the principles under which the law is to be applied, and the rules of general application. The specific provisions deal with individual matters that the law is intended to cover. By contrast, in the common law countries, the pragmatism seems to be the dominant force in the legislation where no distinction is clearly made between general and specific provisions of law. More importantly, in China, the general provisions, though they are usually very abstract, may be used in the courts as the legal authority to render their decisions.

One further difference concerns the function of courts. In common law countries, judges are empowered with law-making authority, and a lower court is bound by the decisions made by the higher court. In China, however, courts are granted no law-making power. Under the 1882 Constitution of China (as amended 2004) and 1979 Organic Law of the People's Courts of China (as amended 1983), the power to interpret law is rested with the Standing Committee of the National People's Congress,[26] and the Supreme People's Court only has the power to interpret the specific questions concerning the application of law in the judicial proceedings.[27] And the Supreme Court's interpretation is normally made in the form of "opinions" or "answers".

Therefore, in China, the people's courts must abide by law or statute but not by precedent, and the higher court decisions have no binding effect on lower courts. In other words, a higher court's decisions may not be cited as legal authority by which the lower court's decisions are made. However, with regard to procedural matters concerning court proceeding, the Supreme People's Court opinions must be followed by the lower courts. Also it should be noted that although the Supreme People's Court's "interpretations" are not the "laws' in China, they have played a significant role in shaping the legal regime of the country and provided courts with "urgently needed gap-fillers".[28]

1.3. Theories of Contract Law

With the development of contract law in China after 1979, Chinese scholars as well as legislators have debated over the contract theories. The debates were mainly on the nature and function of the contract law. Although in general, there has been a consensus that contract law regulates the legal relations in civil and commercial matters and contract is in essence a mutual dealing

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[26] See 1982 Constitution of China, art. 67.

[27] See 1979 Organic Law of People's Courts of China, art. 33.

[28] See Wang Chenguang, *supra* note 9 at p. 21.

between the parties, differences existed as to what contract doctrine would need to be followed and how the contract rules should be addressed under each specific doctrine. During the course of the contact law legislation, there developed four different contract theories that dominated much of the discussions and analysis in this regard.

1.3.1. *Economic Means Theory*

Originated from former Soviet Union, the economic means theory posits business transactions as a series of economic activities in the different stages of productions and among business entities. Under this approach, contract is the economic means employed by the State to manage and facilitate the economic activities. Maintenance of economic order and the state control (management) constitutes the basis for the law to enforce a contract.

The most distinctive feature of the economic means theory lies with its contract definition. It defines a contract as a device to undertake economic activities between enterprises in the process of production. Based on this definition, contract is termed as "economic contract". And further, the term "economic contract" is interpreted to mean a number of things. First, the parties to an economic contract are limited to legal person, and no individual or private person may be a party to such contract. Second, the economic contract basically serves as a tool to implement the economic plans of the State, and its contents and formality are all subject to and affected by the State plans. And third, the purpose of the economic contract is to meet the needs of the production and reproduction as well as business operation under the mandate of the State plans.[29]

The economic means theory possessed a dominant position until late 1980's and significantly influenced the first two contract laws of China, i.e. 1981 Economic Contract Law and 1985 Foreign Economic Contract Law. As Professor William Jones of Washington University observed, for decades in China, a contract was viewed as (a) a device for making the economic plan concrete; (b) the essential basis of the state economic plan; (c) a means for making the state economic plan accurate; and (4) an essential complement to the state economic plan.[30] What was in common in the 1981 Economic Contract Law and the 1985 Foreign Economic Contract Law, which characteristically represented the economic means theory, was that individuals were excluded from being a party to the contract.[31]

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[29] See Su Huixiang, *Theory of Economic Contract Law*, 3–5 (Liao Ning People's Press, 1990).

[30] See William C. Jones, *Basic Principles of Civil Law in China* 201–202 (M.E. Sharpe Inc., 1989).

[31] In the 1985 Foreign Economic Contract Law, thought individual may be a party to a contract, such individual was restricted to foreigner.

1.3.2. *Civil Act Theory*

The civil act theory tries to explain contract from the conduct of the parties. It emphasizes that contract is an important type of the civil act, and is the legal form reflecting transactional relationship between the parties concerned in the market place.[32] According to the civil act theory, the enforceability of a civil act such as to make a contract to a great extent depends on whether such an act is taken on the basis of the consensus of the parties.

Influenced by the Roman law, this theory takes the position that there are three fundamental elements embedded in a contract. First, a contract is created by the mutual act of parties; second, a contract represents the consensus of the parties; and third, a contract is the cause for the occurrence of civil obligation. Therefore, under the civil act theory, contract is a civil act that creates obligation between the parties, and contract law is the law that regulates and enforces such act.[33]

1.3.3. *Agreement Theory*

The agreement theory focuses on the meeting of minds of the parties. Proponents of this theory argue that the contract law is purposed to enforce an agreement that records both intention and expected benefits of the parties. Therefore, the state of the mind of the parties is an essential element in determining the validity and enforceability of a contract. A major difference between the agreement theory and the civil act theory is that the former views it critical as to what the parties would think other than how the parties would act.

But, the agreement theory does not mean to ignore the overt act of the parties. On the contrary, it believes that contract is an agreement consisting of not only promises but also actions. The reason is that in order to have a contract, the parties would have to take certain actions such as formalizing promises and compromising differences. Therefore, to the agreement theory, the promise is no more than a preliminary element to make an agreement while a contract would deal with how an agreement is to be made, modified as well as terminated.[34]

1.3.4. *Exchange Theory*

The exchange theory premises contract on the exchange of goods or products, and its whole idea is that contract helps realize economic movement in any

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[32] See Wang Liming, *the Proposed Draft of the Civil Code of China and Legislative Reasons – Contracts, supra* note 5 at p. 195.

[33] See Li Guoguang, *Explanation and Application of the Contract Law*, 10–12 (Xinghua Publishing House, 1999).

[34] See Jiang Ping, *A Detailed Explanation of the Contract Law of China*, 2–4 (China University of Political Science & Law Press, 1999).

given society. The standing point of this theory is that the market circulation depends on exchange of products and the contract is to facilitate such exchange. Thus, the contract law is to establish a legal norm that makes the exchange of goods or products to take place in an acceptable order.[35]

It seems that the exchange theory regards contract as a record of business transaction activities as well as the channel through which the exchange of products takes place. The problem under the exchange theory, however, is that it does not seemingly tell what the contract is and what the contract would stand for. But this theory appears to try to promote a concept of voluntary exchange in the market place by actually stressing the function of the contract. In this context, the exchange theory may bear some resemblance to economic theory of contract that regards the contract as a mutual transfer of right to achieve maximum net social benefits.[36]

Apparently, the Contract Law does not stand on any of the above theories alone, but rather it takes the stance that combines the civil act theory and agreement theory. The Contract Law makes it clear that contract is an agreement and the agreement is aimed at forming a civil relation containing both contractual rights and obligations. In addition, many scholars in China define the contract law as the law to regulate activities of business transactions among civil actors of equal status. They argue that the contract law applies only to the agreement entered into between the parties of equal status.[37]

What the Contract Law is intended to serve is a three-fold purpose: (a) to protect lawful rights and interests of the parties, (b) to maintain the social economic order, and (c) to promote the construction of socialist modernization.[38] But with regard to what would constitute the basis for the enforceability of a contract, the Contract Law seemingly contains no readily answer, though it emphasizes that a contract, once established according to law, shall be legally binding on the parties.

1.4. Definition of Contract

There was no clear definition of contract in China until 1986 when the Civil Code was adopted. Nonetheless, because of the civil law tradition, a commonly held concept was that "contract in essence is an agreement" and this concept was accepted in the Chinese contract law legislation. For example,

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[35] See Wang Jiafu, *supra* note 7, at pp. 12–16.

[36] The fundamental principle of the economic theory in contract is that if voluntary exchanges are permitted, resources will gravitate toward their most valuable users. See Anthony T. Kronman, *The Economics of Contract Law*, 1–2 (Little, Brawn & Company, 1979).

[37] See Wang Liming, *Study on Contract Law*, Vol. 1, 56–57 (People's University Press, 2003).

[38] See Contract Law, art. 1.

the 1981 Economic Contract Law defined the economic contract as "an agreement between legal persons to ascertain their mutual rights and obligations for purposes of achieving certain economic goal".[39]

Under Article 85 of the Civil Code, a contract is defined as an agreement establishing, modifying and terminating the civil relations between the parties. Following this concept, Article 2 of the 1999 Contract Law further defines contract as an agreement establishing, modifying and terminating the relations of civil rights and obligations between natural persons, legal persons or other organizations of equal status.

As compared with the Civil Code concerning the contract definition, the Contract Law seems to be distinctive in several aspects. First, by specifying natural persons as the parties to a contract, the Contract Law departed from previous contract law legislation where Chinese citizens were excluded from making contract (or from the coverage of contract law). Second, the Contract Law has an emphasis that all parties to a contract are equal civil subjects regardless of their respective status. Third, the Contract Law grants "other organizations" the power to make contracts and therefore extends the coverage of contract law to non-legal persons – an unsolved issue in the 1986 Civil Code.

Thus, for purposes of Contract Law, the definition of contract is generally interpreted in China to include the following legal characteristics:

i. Contract is a "civil legal act" performed by natural persons, legal persons and other organizations of equal status.
ii. Contract is purposed to create, change and terminate relationship concerning civil rights and obligations.
iii. Contract is an agreement expressing the will of two or more parties.[40]

The essence of the "civil legal act" doctrine is to stress that contract is an action of the parties to express their will for civil and economic benefits, and such action must serve a lawful purpose. Scholars in China try to differentiate "legal act" from "de facto act" because the "legal act" is regarded as the act that is premised on the expectation of actors (parties) and will produce anticipated results. Therefore, the "meeting of minds" would be the centerpiece of such legal act. The "de facto act" such as tortious act, however, does not require any meeting of minds nor lead to any mutually expected outcomes.[41]

With respect to the expression of will of parties in the process of contract making, it is crucial that the meeting of minds is achieved. Two basic factors

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[39] See Economic Contract Law of China (1981), art. 4.

[40] See Wang Liming, *A Novel Discussion on Contract Law – General Principles*, 6–7 (China University of Political Science & Law Publishing House, 1996).

[41] See Wang Liming, Study on Contact Law, *supra* note 37 at pp. 7–14; see also Wang Jiafu, *supra* note 7 at pp. 15–18.

are deemed important in making judgment on whether the minds of parties are met. First, the expression of the will must be made mutually. In other words, each party must express to the other what he would bargain for. Second, a consensus between the parties must be reached. Although the parties to a contract each has different business interest, they have to find a common ground on which their mutual interests will best be served. And such a common ground would be the place of the meeting of minds whereby a contract is to be made.

But for making a contract, meeting of minds alone may not be sufficient. What is required then is the "lawful purpose" – a watershed between contract and non-contract. In this sense therefore, contract is further defined by many Chinese scholars as a "lawful civil act". The point is that only if the expression of the will of the parties is lawful and does not violate any law, may a contract so concluded be binding and enforceable. Thus, if an agreement is made for achieving illegal goal, the agreement as such, though there is a "meeting of minds" or "expression of will", will not have any effect of contract.

Another focus of the contract definition in China is the equal status of the parties to a contract. It is a very important concept in Chinese contract law and also has a great practical significance. As noted, China is making efforts moving from a planed economy to a market economy. In the planed economy, the government power in the form of plans reaches almost every aspect of business transactions. Under this circumstance, all business transactions were conducted under the government plans and there was no place to argue for equal status between the contractual parties. In the market economy, however, the contract making power is rested with the contractual parties and the market is the primary force in business dealings. In the market, all parties are equal civilly even if a party is the government agency because by engaging in business activities, the government agency would be treated the same as a private party. Under this notion, the structure of business in China is now in transit from the power-based government plan to market-based contract. During this transit, it is necessary and vital as well to treat the contractual parties equally no matter whether they are private person, government agencies or state owed enterprises.

For purposes of contract making, the Contract Law divides the contractual parties into three categories: natural person, legal person and other organizations. Natural person refers to Chinese citizens, foreigners as well as stateless person. Other organizations are not defined in the law. However, according to a judicial interpretation of the Supreme People's Court, other organizations would mean to include those organizations that are formed under the law with certain assets and organizational structure, but have no independent civil ability and capacity.[42]

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[42] See the Supreme People's Court, *Opinions on the Matters Concerning Application of the Law of Civil Procedures of the People's Republic of China.* Under the Opinions, other organizations would include partnership, social organization not organized as a legal person, branch of a legal person, and village enterprise.

Under the Civil Code, legal person is an association that has capacity for civil rights and civil conducts, and independently enjoys civil rights and assumes civil obligations in accordance with the law.[43] Legal person is different from other organizations in that a legal person independently bears civil responsibilities while an "other organization" does not. In light of civil activities, an "other organization" is used to denote a non-legal-person, which mainly includes the branch of a legal person, institution or social organization possessing no legal person status but engaging in business operation, and business consortium of non-legal-person.

The following case may help illustrate the difference between legal person and other organizations in the determination of civil liabilities.

Zhejiang Provincial Logistic Bureau Truck Fleet
v.
Wenzhou Lucheng Transportation Co-op and Wuma Labor Services Co.

September 12, 1988 [1988] Zhefa Jingshang Zhi No. 38

On November 15, 1986, Plaintiff and Wenzhou Lucheng Transportation Co-op (WLT) singed a bus rental contract. Under the contract, Plaintiff rented out two 45-seat buses to WLT for one and half years and WLT agreed to pay Plaintiff rental fee in the amount of RMB 5000 per month plus RMB 1050 road preservation fees. WLT picked up the buses from Plaintiff in December and paid RMB 5000 for that month on December 31.

Wuma Labor Services Co. (WLS) was incorporated in 1984, and served as the entity that endorsed WLT's application for business license and registration. In return, WLT paid WLS administrative fees. Shortly after WLT operated the rented buses, it was involved in a traffic accident and the two buses were heavily damaged. Because of the accident, WLT defaulted its rental payment to Plaintiff. Plaintiff then brought a lawsuit against WLT for unpaid rents and damages to the buses.

During the trial, it was found that WLT was in very bad financial situation and had no money to pay for anything. Plaintiff then amended its claim and added WLS as related third party on the ground that WLS received administrative fees from WLT. In its decision, the trial court granted Plaintiff request to add WLS as the third party to the litigation and held WLS jointly and severally liable for WLT's debts. Defendant WLS appealed.

On appeal, two legal issues were brought to the Zhejiang High People's Court for clarification. The first issue was whether WLS should be named as third party or co-defendant in the proceeding. And the second issue was whether WLS should be jointly and severally liable for WLT's debts. The High Court split on these two issues. One opinion was that Defendant was actually a branch of WLS and had no legal person status, and therefore, WLS should be held liable. According to this opinion, the lower court's decision should be affirmed with a modification that WLS should be named as a co-defendant, not a third party. An opposite opinion tended to hold that Defendant should be deemed as a legal

[43] See Civil Code, *supra* note 5, art. 36.

person though its status was very special, and therefore WLS should be separated from the Defendant. The opposite opinion suggested remanding the case on the grounds that there was no legal basis to hold WLS liable.

Because the High Court could not reach consent on how the case should be decided, the case then was reported to the Supreme People's Court for opinion.[44] In its reply, the Supreme People's Court asked for more evidence to prove the legal status of the Defendant. According to the Supreme People's Court, if defendant was proven to be an independent enterprise, not a branch of WLS, it would be inappropriate to hold WLS jointly and severally liable. If, however, it was proven that Defendant was indeed a branch of WLS, WLS shall be named as co-defendant and held jointly and severally liable if Defendant was unable to pay its debts.

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In the *WLT* case, the Supreme People's Court made clear that the legal person status was decisive in determining an entity's liability and litigation standing. The implication of the Supreme People's Court opinion is that the "other organization", though not a legal person", may conduct civil activities, such as to make a contract, in its own name with others, but whoever forms or creates such organization would be held jointly and severally liable if the organization is unable to pay for its debts arising from the civil activities.[45]

In regard to legal person, it includes both enterprise legal person and non-enterprise legal person. Enterprise legal person contains state owned enterprises, collectively and privately owned enterprises, publicly listed enterprises, and foreign investment enterprises (known as FIEs). Non-enterprises legal person involves government agencies, institutional units, and other social entities organized as legal person. Since contract is deemed as a civil legal act, all participants in such act shall be equal regardless of their respective social status. The underlying purpose is to promote the idea that contract is a result of free will bargain without coercion or fear on the basis of social status.

Not surprisingly, the contract concept as used in the Contract Law has a clear indication of the civil law tradition. The basic notion is that a contract is (a) the mutual act of the parties, (b) the manifestation of the will of the parties, and (c) the cause of *obligatio*. Partly because of this tradition, the Contract Law explicitly provides that contract is "an agreement". It is interesting to note that most Chinese contract scholars classify American contract law as a typical

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[44] It is a common practice that in Chinese court proceedings, a higher court may be asked for opinion by lower court on certain legal issues that are regarded as substantially important and specifically difficult.

[45] See, Kong Xiangjun, *Analysis and Jurisprudential Research on Difficult Cases in Contract Law*, 16–17 (People's Court Press, 2000).

common law contract system where a contract is defined as "a promise or a set of promises".[46] They then believe that the sharp difference in the contract theory between civil law and common law systems is that in common law system the contract is promise-based while under civil law system the contract is agreement-based.[47]

It is true that in the United States, the study of contract is often regarded as the study of the legal enforcement of promise,[48] and the contract is deemed as nothing more than a promise that the law will enforce.[49] In this regard, an instantaneous exchange is the US is not regarded as a contract because the exchange is entirely instantaneous and neither party makes any promise to the other.[50]

In China, however, the study of contract is the study of how agreement is to be made and enforced. From the viewpoint of the Chinese contract law scholars, "promise" is not a mutual act and at least on its face it does not necessarily require a mutual assent. Perhaps, a closer look at the gist of the contract law in each system would help understand the difference. In the United State, the contract law focuses on "why a promise or a set of promises should be enforced" while in China the contract law has an emphasis on "what would constitute an agreement and how an agreement would be enforced". Additionally, a contract in China is generally regarded as a device to create, modify or terminate the civil relations through an agreement between the parties.[51]

Also note that in Chinese contract law there is no such concept as "quasi-contract" because under the concept of *obligatio*, certain obligations across over the line between contract and torts could be categorized as either unjust enrichment or *negotiorum gestio* (voluntary service).[52] For example, in the United States, the obligation to return money paid mistakenly to a person to whom it is not owed is characterized as a quasi-contact obligation, while in China it is the obligation arising under the doctrine of unjust enrichment.

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[46] The Restatement defines a "contract" as "a promise of a set of promises for the reach of which the law gives a remedy, or performance of which the law in some way recognizes as a duty" *Restatement (Second) of Contracts* § 1.

[47] See Wang Jiafu, *supra* note 7 at pp. 254–258.

[48] See Robert E. Scott & Jody S. Kraus, *Contract Law and Theory* (3rd Ed), 1 (LexisNexis, 2002).

[49] See Jeffrey Ferriell & Michael Navin, *Understanding Contracts*, 1 (LexisNexis, 2004).

[50] See Brian Blum, *Contracts, Examples and Explanations* (3rd Ed), 5 (Aspen, 2004).

[51] See Li Guoguang, *supra* note 33 at p. 11.

[52] To illustrate, under Article 93 of the Civil Code, if a person provides management or service in order to protect another person's interests when he is not legally or contractually obligated to do so, he shall be entitled to claim from the beneficiary the expenses necessary for such management or service.

1.5. Application of the Contract Law

Since a contract in China is characterized as a kind of *obligitio,* it does not cover civil relations concerning personal status. Therefore, the Contract Law does not apply to any agreement that involves marriage, adoption or guardianship. Such exclusion is entirely based on the rationale that for purposes of Contract Law a contract is an agreement dealing with relations of non-personal or non-family status.

On the other hand, according to Chinese contract law scholars, the main thrust of contract law is to deal with property related civil relations and regulates civil matters concerning business transactions. Thus, although an agreement may be made in relation to personal status such as marriage, adoption and guardianship, such agreement does no involve business transactions and therefore is not governed by the contract law in China. More importantly, there exists a historical legal principle in China that marriage is not a contract.[53] However, an agreement concerning distribution of family property, though it involves personal status, shall nevertheless be governed by the contract law.

In addition, the Contract Law is not applicable to the agreements of administrative nature. By administrative nature, it means that the relationship between the parties is not a civil but administrative one. In other words, the agreement so reached is the means by which government supervises the fulfillment of the agreement for public interest. An example in this regard is the environment protection agreement. This agreement is as a matter of fact a promise made by a party (e.g. a real estate developer) to the government authority for the compliance with the requirements of environment protection.[54] Other agreements such as family planning agreement, or agreement concerning government appropriation, tax and fee schedule, etc. do not fall within the domain of the law of contract either because they are clearly administrative in nature.

Furthermore, the internal managerial relationship of a legal person or other business organization is also precluded from application of the Contract Law. An example is the agreement between a company or its production plant and its employees for the production purpose. The agreement as such is not a contract stipulated by the Contract Law because it is made as a result of production responsibility system employed by the company, and basically serves as managerial device for internal production of the company.[55]

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[53] In China, marriage, including divorce, is exclusively governed by the Marriage Law.

[54] See Gu Angran, *Talks on the Contract Law of China*, 8 (Law Press, 1999).

[55] See Gu Angran, *Explanations to the Contract Law of People's Republic of China (Draft)*. The Explanation was made to delegates of the Second Session of the National Conference of the Ninth National People's Congress on March 9, 1999. It was on this Session that the Contract Law was passed.

A related issue is the employment contract. During the drafting of the Contract Law, it was advocated that the employment contract ought to be covered by the Contract Law. However, due to the resistance from the labor departments arguing that since the employment contract was already regulated by the Labor Law, there would be no need to have it covered in the Contract Law. Despite the fact that the Contract Law contains no employment contract, the common understanding is that the principles and basic provisions of the Contract Law shall be equally applicable to the employment contracts.[56]

A thorny issue in the law of contract is the contract for transfer of right to the use of land. Unlike many other countries, China is the country where no private person may own any piece of land. An individual in China may now own a house or building, but the ownership does not reach the land where the house or building stands. Under the 1982 Chinese Constitution (as amended 2004), land in the cities is owned by the State and land in the rural and suburban areas is owned by collectives except for those portions that belong to the State as prescribed by law.[57]

The ownership is China is divided into three categories: State ownership, collective ownership and private ownership. In order to better protect the property rights, China is now drafting its first property law named "The Law of the Right of Things". The latest draft was published by the Standing Committee of the National People's Congress on July 8, 2005 for comments from the general public. Under the draft Law of the Right of Things, the scope of private ownership is limited to living materials such as house, income and articles for daily use, and legally obtained production materials such as production tools and raw materials.[58] Interestingly, the private person is defined to include citizen, individual business, leasing-holding farm household, foreigner, stateless person, as well as individually wholly owned enterprise (proprietorship) or foreign enterprise.[59]

Thus, the real estate or real property, as used in China, is referred to the land use right and anything permanently affixed to the land, such as building. The 1982 Constitution prohibits any organization or individual from appropriating,

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[56] The Labor Law of China was promulgated by the Standing Committee of the National People's Congress of China on July 5, 1994, effective on January 1, 1995. Chapter III of the Labor law directly deals with labor contracts and collective contracts. Under Article 16, a labor contract is an agreement that establishes the labor relationship between a laborer and employing unit and defines the rights and obligations of respective parties. It is also required that a labor contract shall be concluded where a labor relationship is to be established.

[57] See 1982 Chinese Constitution, art.10.

[58] See the Law of Things of the Republic of China (Draft), Article 66, (China Democracy and Legal System Press, 2005).

[59] See *id*., art. 266.

buying and selling or otherwise engaging in the transfer of land by unlawful means. Organization or individual, however, may acquire the right to the use of land and such right may be transferred according to law.[60] The land use right is also provided in the Land Management Law of China.[61]

During the drafting of the Contract Law, the right to the use of land was heavily debated. The major issue was whether a contract concerning transfer or sale of the right to the use of land should apply the Contract Law. Proponents argued that since the parties to the contract of transfer or sale of the right to the use of land are the actors of civil activities and possess equal status in the transaction, such contract shall be included in the Contract Law.

The opponents, however, insisted that based on its nature, the land use contract should be precluded from the application of Contract Law. According to the opponents, the right to the use of land is created as a result of government approval, and therefore the parties to the contract concerning transfer or sale of the right to the use of the land do not necessarily have the equal civil status. The reason is that the contract involving the right to the use of land is unique because (1) the government, as the owner of the land, retains the ultimate control over the land, (2) the right to the use of land is subject to a term limit (normally 75 years) though the term may be extended, and (3) the government has the right to interfere with the use of the land if it is believed that the land is not being used as intended.[62] Because of the highly controversial nature of this issue, the Contract Law keeps silent about the contract for the transfer of land use right.

On March 24, 2003, the Supreme People's Court issued an "*Explanation to the Application of Law to the Cases Involving Disputes over the Contract of Sale of Marketable Residential Housing*".[63] Under the *Explanation*, a contract for the sale of marketable residential housing shall be governed by the Contract Law. According to the Supreme People's Court, a contract for the sale of marketable residential housing is defined as the contract by which the real estate

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[60] Art. 10, the Constitution of the People's Republic of China (1982).

[61] The "Law of Land Management of People's Republic of China" (Land Management Law) was adopted on June 25, 1986 and was amended on August 29, 1998. The amended Land Management Law took effect on January 1, 1999.

[62] See Sun Lihai, *Selection of Legislative Materials of the Contract Law of China*, 205–206 (Legal Press) (1999).

[63] The Explanation took effect June 1, 2003. See Supreme People's Court "*Explanation to the Application of Law to the Cases Involving Disputes over the Contract of Sale of Marketable Residential Housing*". A Chinese version of the Explanation is available at http://www.law-lib.com.cn/law/law_view.asp?id=74535. The term "marketable" as used here is to differentiate government allocated or subsidized housing from a purely commercial one. The former may not be freely transferred (either not transferable or subject to limitations for the transfer).

developer (seller) sells to the public the housing to be built or already built and transfer the title of the housing to the buyer who pays for the housing.[64]

However, under the *Law of Urban Real Estate Management of China*, which was adopted on June 5, 1994, when real estate is transferred or mortgaged, the title of the housing and the right to the use of the land to which the housing is affixed shall be simultaneously transferred or mortgaged.[65] Thus, is seems that the Supreme People's Court has actually expended the application of the Contract Law to the transfer of land use right when such transfer is associated with the transfer of the affixture to the land.

2. Contract and Socialist Market Economy

Once again, after 1949 until 1978, China's economy was known as highly centralized planned economy. Such planned economy was established on the model of former Soviet Union, and developed during China's first five-year plan period (1953–1958). The most notorious features of the planned economy were the mandate of state plan and the dominance of public ownership (state and collective ownership), and as a result, no private ownership or property existed or was allowed to exist.[66] As we have discussed, under the planned economy, the state became the economic player and the state plan virtually controlled all business transactions. Though occasionally, the state owned enterprises were asked to deal with each other through an agreement, such agreement was nothing but the tool to implement the state plan, and the parties to the agreement barely had any choices of their own. Therefore, the state plan in fact had made it totally meaningless to have any contract.[67]

In 1978, awaken from the edge of bankruptcy of the nation, Chinese government started to explore the new direction that could help revive the country's economy. The boldest step was the adoption of the policy of "economic reform and opening-up to the outside". The economic reform was intended

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[64] See *id*. art. 1.

[65] See, *Law of Urban Real Estate Management of China*, art. 31, effective on January 1, 1995, available at http://www.law-lib.com.cn/law/law_view.asp?id=253.

[66] In mid 1950s, China launched a national campaign to "transform private ownership into socialist one". Aimed at extinguishing all "capitalist elements", this nationwide "socialist transformation" helped establish the absolute control of public ownership over the economy. By the end of the first five-year plan (1958), the state owned enterprises amounted to about 80% of the national economy. See Wu Jinglian, *A Road to the Market Economy*, 129 (Beijing University of Industry Press) (1992).

[67] See Zhang Guangxing, *General Introduction to the Law of Obligations*, 14 (Law Press) (1997).

and purposed to establish a new economic system and to build a modern enterprise scheme. But at the heart, the economic reform essentially dealt with three things: "socialist system", "private ownership", and "market economy". In this connection, there were three questions that puzzled everyone at the outset of the economic reform:

a. Was the private ownership necessarily contradictory to the socialist system to which China sticks? In other words, could the socialist system embrace private ownership, in addition to public one?
b. Did the market economy have to be established on the private ownership economy, or could it be adopted in a pubic-ownership-based socialist system? And
c. Could both public and private ownership co-exist in a market economy with the public ownership as the core?

Apparently, there was no immediate answer to these questions. However, driven by the urgent need for making the country prosperous, Chinese government followed Mr. Deng Xiaoping's famous philosophy of "walking across a river by touching the stones underneath" and cautiously moved forward. Interestingly, during the process of the economic reform in the past two decades, China's economy system was redefined from "socialist planned economy" to "socialist planned commodity economy" in 1984, and then to "socialist commodity economy" in 1987, and finally to "socialist market economy" in 1992. One year later in 1993, the "socialist market economy" was formally adopted as a basic economic system of the nation in the Chinese Constitution through an amendment. This was not simply the change of term, but this typically reflected the change in the country's economic system and the change in ideology of the nation.

With regard to recognition of the private ownership in China, it can be best explained by looking at the changes in the Chinese Constitution. There have been four Constitutions in Chin since 1954, and current one is the Constitution that was adopted in 1982.[68] Prior to 1982, private ownership had long been deemed as something that the socialist system must get rid of. The 1982 Constitution, at the time it was adopted, did not explicitly recognize the private ownership as well, though Article 11 of the Constitution stated to protect the lawful interest of " urban and rural worker's individual business".

On April 12, 1988, Article 11 was amended to clearly provide that the State permits the private sector of economy to exist and develop within the limit

[68] The four Constitutions were adopted in 1954, 1975, 1978, and 1982 respectively. The 1982 Constitution was amended four times in 1988, 1993, 1999 and 2004 respectively.

prescribed by law, and that the private sector of economy is a complement to the socialist public economy.[69] Eleven years later, on March 15, 1999, Article 11 was amended again. It now provides that the non-public sectors of the economy such as individual or private sectors of the economy, operating within the limit prescribed by law, constitute an important component of the socialist market economy.[70]

Since the 1982 Constitution was amended in 1993, China has been committed to the practice known as "socialist market economy".[71] As an important gesture of implementing the socialist market economy, the 1993 Amendment changed "State-run enterprises" to "State-own enterprises". Though the term "socialist market economy" was never well defined, it clearly reflected the ideological thinking of Chinese communist government: On the one hand, the country must stay with the socialism where the public ownership (or state ownership) remains as dominant force; And on the other hand, in order to make the country strong, its economic development shall be driven more by market force than by the government plans of administrative nature.

There was a belief in China that the market economy might also serve the socialist need because in its development, the market economy, though originated in free enterprise system, in deed took different forms.[72] Therefore, since the concept of "socialist market economy" emerged in China in 1980s, there has been an attempt to find the "equilibrium" between socialism and market economy.[73] In the meantime, in order to abandon the planned economy that existed in China for decades, Chinese government repositioned China as the

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[69] See 1988 Amendments to the Chinese Constitution.

[70] See 1999 Amendments.

[71] Prior to 1993, Article 15 of the Chinese Constitution provided: "the State practices planned economy on the basis of socialist public ownership. The State ensures the proportionate and coordinated growth of the national economy through synchronized balance of economic plans and the supplemental role of the market force". The 1993 Amendments changed this article into the following: "The State practices the socialist market economy. The State strengthens economic legislation and improves macro regulation and control".

[72] Chinese scholars divide the market economy of the world into different models. The major ones are US Model – free market economy, French Model – administrative market economy, and German Model – social market economy. See Liu shiming, *Market Economy Models in the Modern World*, 648–649 (Guangdong Tourism Press, 1998).

[73] In November 1979, when Deng Xiaoping introduced his idea that "socialism may also practice market economy", the term "market economy" – used to be a taboo in China, was first associated with the term "socialism". In October 1982, Deng Xiaoping again pointed out that there existed no fundamental contradiction between socialism and market economy. Then during his famous tour to the south in 1992, Mr. Deng further emphasized that market economy was not the line that differentiates socialism and capitalism. See Ding Bangkai, *the Law of Socialist Market Economy*, 6 (South East University Press, 2002).

country that is and will long be in the "preliminary stage of socialism" where market remains the primary force of the economy.[74]

In March 2004, China for the fourth time amended its 22 years old Constitution.[75] The 2004 Amendment that contain 14 articles is said to have made substantial changes to the Constitution, and one of the most spectaculars changes is perhaps the bold move toward more protection of private ownership in China.[76] Three articles in the 2004 Amendment reflect such move. The first one is the requirement of "compensation" when the State expropriates or requisitions land or private property of citizen for public interest. The second one is the adoption of term of "non-publicly-owned economy" to include individual and private economies. And the third one is the explicit statement that the lawful private property of citizen shall be inviolable.

A new development concerning China's current economic structure is that after joining the WTO in 2001, the country has been making efforts to promote its "market economy" status and to have the status recognized by other countries. The purpose is to try to best utilize all benefits the WTO that is structured on the market economy may provide. In April 2004, New Zealand became the first county that recognized China's market economy status. By May 2005, some 38 countries, including Russia and 11 European countries, had announced their recognition of the market economy status of China.[77]

However, it is important to keep in mind that the market economy, or more precisely the socialist market economy, at least for the time being, is not purposed to turn China into a private-ownership-premised country, nor is it intended to eliminate the state plan. According to many Chinese scholars, socialist market economy could be characterized to include three distinctions: (1) the pillar of the socialist market economy is public ownership though the public ownership

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[74] When 1982 Constitution was amended in 1993, a new paragraph was added into the Preamble of Constitution. It is provided that our country is now in the preliminary stage of the socialism, the fundamental task of the nation is to put-together all sources to carry-on the construction of the nation's modernization in accordance with the theory of building socialism embedding Chinese characteristics.

[75] The 2004 Amendment was adopted the National People's Congress on March 14, 2004 with 2,863 votes in favor, 10 against and 17 abstentions. The passage of the 2004 Amendment was acclaimed by Chinese Communist Party as the triumph of constitutional legislation in China.

[76] Another change that has received the world attention is Article 24 of the Chinese Constitution. Article 24 essentially makes it constitutional mandate that the State respect and protect human rights. It is the first time that the human rights protection is included in Chinese Constitution.

[77] After Iceland and China signed in May 2005 a Memorandum on Strengthening the Corporation in Economy and Trade between China and Iceland where Iceland announced to recognize China as having market economy, the number of countries that have recognized China's market economy status reached 38. For more information, see http://www.mofcom.gov.cn/aarticle/zhongyts/x/200501/20050100327818.htm.

co-exists with private and other ownership; (2) the distribution system in the socialist market economy is the one containing multiple distribution forms with a focus on the socialist distribution principle of "from each according to his ability to each according to his work"; and (3) the ultimate goal of the socialist market economy is to achieve common wealth.[78]

Nevertheless, adoption of the socialist market economy necessarily demanded to change the way that business used to be operated and managed in China. A significant change was obviously the shift of the business decision-making function from planning authority to individual entity or private person. Consequently, although the state plan still played a role in the nation's economy, contract-based transactions became the major components of the economy. Contracts then replaced state plan and became the basic legal device in engaging business activities.

It is true that in the early phrase of the economic reform, contracts were specially named as economic contracts in order to stress certain relationship between contracts and implementation of state plan. But, ever since the contracts reemerged as a major means in dealing with business affairs, "equality" and "mutual benefit" between the parties have been widely recognized as the basic norms in making a contract. In this sense the "equal status" (meaning equal footing) of the parties to a contact was being hailed as critical to the contract making. It would then require that the will of the parties to a contract be respected.[79]

Therefore, it is fair to say that though the exact meaning of the socialist market economy requires further debates the contracts undoubtedly have evolved to be the primary player in Chinese economy because it has become the Chinese legislative belief that contract law is the basic legal framework of market economy.[80] However, as discussed below, the state plan to certain extent still remains influential in the process of making contracts.

3. Contracts and State Plan

As being the case, at the early stage of modern Chinese contract law legislation, there was a strong preference to the implementation of the State plan. The major reason was the attempt to differentiate the kind of market economy

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[78] See Ding Bangkai, *supra* note 74 at p. 7.

[79] The "equal status" is provided as basic principle in both the GPCL and Contract Law. Article 3 of the GPCL provides that parties to a civil activity shall have equal status. Under Article 3 of the Contract Law, the parties to a contract shall have equal legal status and no party may impose its will on the other party.

[80] See Hu Kangsheng, *Explanation to the Contract Law (Draft) of the People's Republic of China*, published in *Selection of Legislative Materials of Contract Law of the People's Republic of China*, See Sun Lihai, *supra* note 63 at pp. 3–7.

that China was supposed to adopt from the free market economy that existed in many west countries. It was believed that the contracts should become a useful tool to help implement the State plan because all business activities ought to be under the control of the State plan.

Thus, in 1981 Economic Contract Law, contracts were deemed to be subject to the primacy of the State plan. Article 4 of the Economic Contract Law explicitly provided that making economic contracts should meet the requirements of the State plan. And Article 7 further provided that an economic contract should be null and void if it violated the state plan. Clearly, under the 1981 Economic Contract Law, no contract may become obstacle to the State plan because a stated purpose of the 1981 Economic Contract Law was to ensure the implementation of the State plan.[81]

The State plan in China is normally divided into mandatory State plan and directory State plan (or State guidance plan). The mandatory State plan refers to the pan that must be carried on and it is the device that the state uses to directly manage the nation's economy. Therefore, the mandatory State plan is being implemented through an "administrative order" of the state planning authority. The directory State plan serves as the guidance for the enterprises to conduct their businesses, and the enterprises are allowed to maintain certain flexibility to make their business plan according to their business need.

Generally, the state plan during the course of implementation is operated in the form of quota. In accordance with 1981 Economic Contract Law, for business transactions concerning products and items within the scope of mandatory State plan, the economic contracts must be made under the quota provided by the State. If the parties to an economic contract could not reach consent, the matter should be handled by their superior authority. If the business transactions involved the products or items falling into the category of the directory State plan, the economic contracts may be concluded according to the reality of the entities concerned with reference to the State quota.

When the Civil Code was adopted in 1986, an effort was made to separate contracts from State plan to the extent that parties are being given more power to make business decisions on their own. Despite the fact that the Civil Code prohibits any civil activity from undermining state economy plan, it does not require that contracts be made under the State plan. Accordingly, the 1981 Economic Contract Law was amended in 1993, and major changes were the elimination of preference to the state plan. In Article 1 of the amended Economic Contract Law, a stated purpose of the contract law was changed

[81] See 1981 Economic Contract Law of China, art. 1.

from "ensuring the implementation of State plan" to "ensuring a sound development of the socialist market economy".[82]

The Contract Law is said to have departed further from the planned economy tradition and to be more market oriented than previous contract legislation. First of all, the Contract Law further strengthens the principle of "equal status" by emphasizing that no party may impose its will on the other. The purpose underlining the "equal status" principle is to ensure that a contract is the result of the free will of the parties to the contract. Secondly, the Contract Law for the first time does no use the term "State plan" in the contract law legislation, and instead the term "State mandatory task or State purchase order" is used to refer to the State mandate in the making of contracts. Third, the Contract Law specifies the contracting party to include natural person, legal person, or other organization, and therefore marks an end of the preclusion of individuals (natural person) from making contacts.[83]

Under Article 38 of the Contract Law, in case the State issues a mandatory task or a state purchasing order based on necessity, the relevant legal persons or other organizations shall conclude contracts between them in accordance with the rights and obligations as stipulated by the relevant laws and administrative regulations. Article 38 is only the provision in the Contract Law where the state plan is addressed, and the contract concluded under Article 38 is also called "State mandatory task contract" or "State purchasing order contract". What could be inferred from Article 38 is that in the socialist market economy that China is undertaking, the impact of the State plan on contracts still exists.

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[82] The 1981 Economic Contract Law of China was amended on September 2, 1993. An English translation of the Economic Contract Law (1993) is available at http://www.qip.net/chinalaw/prclaw19.htm.

[83] In 1981 Economic Contact Law, the contract was defined as an agreement determining mutual relationship of rights and obligations between the legal persons in order to realize certain economic goals. In 1993 when the Economic Contract Law was amended, it was provided that the Economic Contract Law applies to contracts entered between legal persons who are equal civil parties, other economic organizations, self-employed workers or traders and rural households operating on contract for the purpose of realizing certain economic goals and clarifying each other's rights and obligations. It was clear that under the Economic Contract Law, natural person were not eligible for being the parties to a contract. See *id*. Although the Technology Contract Law that was adopted in 1987 applied to contracts made between legal persons, between legal persons and citizens, and between citizens, which establish civil rights and obligations in technical development, technology transfer, technical consultancy and technical service, it excluded the contracts in which one party is a foreign enterprise, other foreign organization or foreign individuals. An English translation is available at http://www.qip.net/chinalaw/prclaw21.htm.

However, it should be noted that with the development of the market economy, the State plan seems to be playing less and less active role in China.[84] An important aspect is that the State has been shifting its planning authority from the micro control to the macro control of the nation's economy, and has been relying more on economic and legal means to manage the economy. In contract area, the much of the focus of the State has been on the State owned or controlled enterprises.[85] Under Article 38, the "State mandatory task contract" or "State purchasing order contract" only applies to "relevant legal persons or other organizations". Most of such relevant legal persons are the State owned or controlled enterprises.

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[84] For example, the number of the state-owned or controlled enterprises has been declining over the years. In 1998, the state-owned or controlled enterprises were 238,000. By the end of 2003, the number decreased to about 150,000. As of October 2004, the state owned industrial enterprises were 31,500, only about 15% of total industrial enterprises in the country. See the State-owned Assets Supervision and Administration Commission of the State Council, available at http://www.sasac.gov.cn/gzjg/qygg/200412010040.htm. Take Beijing for example, by July 2005, of a total of 1,015,751 enterprises in the area of Beijing, some 819505 are private or individually owned enterprises. See Economy Daily, September 15, 2005 at page 9. Also in Liaoning Province, foreign investors are now allowed to take full control of all State-owned enterprises in the province except coal mine industries. See China Daily, September 16, 2005, at page 1.

[85] State controlled enterprises are referred to these publicly held companies where the State owns majority shares. Under the Company Law of China (adopted December 29, 1993, effective July 1, 1994 and amended December 25, 1999), the companies in China take two different forms: company with limited liability and company limited by shares (or stock company). A State own enterprise may be structured as a limited liability company (wholly State owned) or a company limited by share. In the latter case, the State is a shareholder in the company.

Chapter II
Freedom of Contract in Chinese Concept

It has been well held in western countries that it is in the public interest to accord individuals broad powers to determine their affairs through agreement reached by themselves.[1] This is the premise on which the freedom of contract stands. Derived from the theory of free economy, the freedom of contract has become the corner stone of the modern contract law and the most important principle in contract system ever since the French Civil Code was adopted in 1804.[2] To be more explicit, in an open market economy, it is essential that businessmen or entities have right to decide freely to whom they will offer their goods or services and by whom they wish to be supplied, as well as freely to agree on the terms of individual transactions.[3]

Unfortunately however, the concept of freedom of contract was not accepted in China until recent years though much of the Chinese contract theory has its intellectual parentage from the civil law (or continental law),

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[1] Farnsworth, *Contracts* (3rd Ed), 321–322 (Aspen Law & Business, 1999).

[2] The idea of freedom of contract was originated from Adam Smith's theory of free economy where individuals were regarded as the best judge of their own affair. Inspired by free market incentives, classic contract law theory saw contract as the convergence of the wills of the contracting parties, which was later interpreted as the "meeting of minds". See generally, Peter Linzer, *A Contracts Anthology* (2nd ed), (Anderson Publishing Co., 1995).

[3] See comments on Article 1.1 of UNIDROIT Principles.

especially the German and French laws. Even in the early 1980s when China had determined to revitalize its economy by introducing western experiences into the nation, the freedom of contract remained precluded due to the concern about the influence of the "capitalist ideology" as well as the unwanted impacts on the state plans. This concern was clearly reflected in the 1981 Economic Contract Law where no freedom of contract was provided.[4]

There are a number of factors that would contribute to China's denial of, or resistance to, freedom of contract. First, under the scheme of the centrally planned economy, it was impossible for individuals or business entities to have a free access to the market. Every business sector was strictly tied with the State's economic plan, and development of economy was not driven by market force but by the central government through pre-determined plans.[5] Second, because the State plan was the major player in China's economy, freedom of contract barely had any room in the economy. Therefore, it was inconceivable that anyone at that time in China would think of having right to freely enter into a contract with others. Third, the freedom of contract had long been criticized in China as a capitalist concept – an "enemy" to the socialist system.

The two-decade reform that was aimed at making China economically strong in one respect helped decentralize the economic structure of the nation and in the other respect made it possible for the enterprise and private person to have more power in business decision making process. As a result, the outcry for less government interference in commercial activities grew so significantly that the need for party autonomy in business transactions became imminent. In response, the government and its agencies were called to refrain themselves from making decisions for the business entities. As far as contracts were concerned, much of the power to make them was then rested with the parties.

The Contract Law expressly grants to the contracting parties the right to enter into contract voluntarily, and prohibits any unlawful interference. The most noteworthy provision in the Contract Law is Article 4, which is widely

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[4] When the Economic Contract Law was amended 12 years later in 1993, a progress made toward the freedom of contract was to provide that in concluding an economic contract, the parties must implement the principles of equality and mutual benefit, and achieving agreement thought negotiation. No party shall impose its will on the other party and no unit or individual may unlawfully interfere. See Economic Contract Law (1993), art. 5. An English translation of the Economic Contract Law is available at http://www.qip.net/chinalaw/prclaw19.htm.

[5] This type of economy was modeled after the former Soviet Union, and also described as "bird-cage economy", which was advocated by late Chinese vice premier Chen Yun. Mr. Chen was in charge of the nation's economy for decades except for the period of Cultural Revolution.

acclaimed by the Chinese legislator as having adopted the principle of "party autonomy" in contract.[6] Under Article 4, the parties to a contract shall have the right to voluntarily enter into a contract in accordance with the law, and no unit or individual may unlawfully interfere. This provision is said to represent a dramatic change in favor of freedom of contract in China's contract legislation.

When the drafting of the Contract Law started in 1993, there was a strong voice from legal scholars and some legislators that the freedom of contract should be incorporated as a general principle into the Contract Law. As a matter of fact, in the first draft of the Contract Law in January 1995, the freedom of contract was provided as a general principle of the Contract Law. It stated that "the parties shall have the freedom of contract within the boundary of law and no unit, organization, or individual shall unlawfully interfere with."[7] However, this provision was completely rephrased in the 1997 draft that was released on May 14, 1997. The changed provision read: "the parties shall have the right equally and voluntarily to make contract according to law. None of the parties shall impose its own will on the other and no unit or individual shall unlawfully interfere with the parties' right."[8] One year later, this provision was changed again in the 1998 draft (August 20, 1998), which was adopted in 1999 as the current provision of the Contract Law.[9]

Interestingly, in almost all published materials offering explanation of the Contract Law, the principle of "making contract voluntarily" is interpreted to mean that the parties have freedom to make contract in accordance with law.[10]

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[6] Sun Lihai, et al, *A Practical Explanation to the Contract Law*, 22–24 (Industry and Commerce Press, 1999) (here in after referred to as Exlanation).

[7] See *the Introduction to the Contract of Law of China and its Major Drafts*, edited by the Civil Law Office, the Legal Affairs Committee of the Standing Committee of the National People's Congress, 8–18 (Law Press, 2000).

[8] *id.* at p. 113.

[9] *id.* at p. 173.

[10] See, *inter alia*, Jiang Ping et al, *A Detailed Explanation of the Contract Law of China*, (China University of Political Science & Law Press, 1999); Yang Lixin et al, *Implementation and Application of the Contract Law of China*, (Jilin People's Publishing House, 1999); Liu Wenhua et al, *Detailed Explanation and Typical Cases of the New Contract Law*, (Word Books Press, Co., 1999); Sun Lihai et al, *A Practical Explanation of the Contract Law*, (Industry and Commerce Publishing House, 1999); Research and Economic Law Offices of the General Office of the Standing Committee of NPC, *Explanation and Practical Guidance of the Contract Law of China*, (China Democracy and Legality Press, 1999); Research Office of the General Office of the Standing Committee of NPC, *A practical Guidance of the Contract Law of China*, (Huawen Publishing House, 1999); Zhao Xudong et al, *Interpretation of Terms and Phrases related to the Contract Law*, (the People's Court Publishing House, 1999).

Although Article 4 does not explicitly use "freedom of contact" – the term commonly accepted by western countries and international organizations,[11] it apparently indicates that in the Chinese contract legislation, the freedom of contract in the form of party autonomy is recognized as a general principle governing contracts.

The use of the term "making contract voluntarily" in China other than "freedom of contracts" as commonly used elsewhere may also serve as an interesting indication that China is the country where people prefer to have something that could be claimed as that of their own. A very popular phrase employed in China in this respect is the "Chinese characteristic", meaning 'unique' in China.[12] Pragmatically, this phrase would reflect a reality that China welcomes foreign ideas, but as always, does not want to simply follow them without Chinese distinctions.

1. Conception of Freedom

Freedom, individual freedom in particular, used to be labeled as bourgeois ideology or philosophy in China because it was criticized to serve the sole purpose of promoting individualism. Although since 1954 when the first Constitution was adopted it has been provided that Chinese citizens shall enjoy the freedom of speech, press, religion as well as demonstration, and the personal liberty of a citizen shall not be infringed, such freedom was never well respected or protected. Historical reason aside,[13] this phenomenon was a product of the overly stated supremacy of the State interests.

Under the 1982 Chinese Constitution (as amended 2004), the State protects three different interests, namely State interests, collective interests and private interests (or individual interests). The State interests and collective interests are also jointly called public interests. For a long time during the past decades in China, an infallible principle was that the State interests controlled all

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[11] Freedom of Contract is provided in UNIDROIT Principles as a basic principle in the context of international trade. Realizing the paramount importance of the principle of freedom of contract, Article 1.1 of UNIDROIT Principles (Freedom of Contract) stipulates that the parties are free to enter into a contract and to determine its content.

[12] This term is also used politically in China to describe the direction the nation is moving toward under the control of the communist party as "socialist road with Chinese characteristic".

[13] Under Confucianism, three cardinal guides must be observed in order to maintain the stability of the country. The three cardinal guides were "ruler over subject, father over son and husband over wife".

over collective and private interests. There seemed to exist a golden rule for maintaining the supremacy of the State interest, and the rule as such was commonly stated as "subordinating of private interest to both the State and collective interests, and subordinating of both private and collective interest to the State interest." Thus whenever there was a conflict between private interests and the State or collective interests, the former must yield to the latter, no matter what.

Unlike in western countries, freedom in China is not considered as the right that inheres in citizens, rather it is deemed as a special privilege granted by the ruling authority. Put differently, the freedom, if any, is not inherent but given. Consequently, the extent to which people may enjoy freedom would very much depend on the mercy of government. In this context, the concern about whether people had the freedom or had really enjoyed the freedom was hardly the center of attention in the nation. The typical example is the 10-year Cultural Revolution during which the freedom, personal liberty and private interest were totally ignored and deprived. Since 1979, many efforts have been made in order to improve and respect private interests. Still, there is a long way to go.

A fundamental difference between the concept of freedom-inherent and notion of freedom-given is how government would function in dealing with people's freedom. If the freedom is inherent, people could have it unless restrictions are imposed by the law on the exercise of the freedom. But if the freedom is given, people will not have the freedom until it is granted by the government. Additionally, in the situation where the freedom is deemed inherent, it may not be taken away without due process of law or other compelling grounds. It may not be the case if the freedom is regarded as a granted right because the right does not belong to the grantee at the first place any way.

The history of drafting the Contract Law may help illustrate how the concept of freedom was dealt with in Chinese contract law legislation. During the drafting period, many scholars strongly advocated to have the notion of the freedom of contract provided in the Contract Law. But they were encountered with various resistances against using the term of freedom of contract. The resistances seemed to come from a fear that the freedom of contract may mean something beyond what the Contract Law is intended in terms of the parties' right of making a contract.

In its official explanation to the 1998 draft contract, the Legal Affairs Committee (LCA) of the Standing Committee of NPC stated that the freedom of contract was referred primarily to party autonomy, meaning that the parties have the right to freely enter into a contract and determine the contents of the contract. But the LCA further pointed out that the freedom of contract was not absolute and in many countries such freedom was limited to the legally allowable extent. They hence concluded that it might not be proper in China

to simply adopt the freedom of contract.[14] In their opinion, the freedom of contract principle in the Contract Law would need to be addressed to embrace the Chinese characteristics. As a result, the term "freedom of contract" was replaced by "making contract voluntarily" in the Contract Law.

Nevertheless, a quite number of scholars in China believe that freedom as applied to contract would mean the free will of the parties to determine their own affairs through negotiated agreement, and would require that the freely expressed will should be honoured and protected. It therefore seems undisputable that the freedom of contract has been very well received among Chinese scholars albeit the differences in understanding of the essence of this long established contract principle. Given the impact of China's ex-system of the planned economy, the implication of the freedom of contract in China is believed to have to emphasize two major points: respect for parities' will and no government interference.[15]

2. Right of the Parties to Contract

The main tenet of the freedom of contract is that the parties have the right to determine and arrange their business affairs themselves without interference.[16] The right of contractual parties to decide freely to whom they will offer their goods or services and by whom they wish to be supplied, as well as the possibility for them to freely agree on the terms of individual transactions, are deemed as the cornerstones of an open, market-oriented and competitive international economic order.[17]

Certainly, in modern contract law, despite the tension between the individual freedom and the growing social control, the idea of private autonomy remains influential.[18] Admittedly however, the tension in China seems to be more intensive due to the strong interest in maintaining government control.

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[14] Sun Lihai, et al, *Selection of Legislative Materials on the Contract Law of the People's Republic of China*, 8–12 (Legal Press, 1999).

[15] See *id*., See also Wang Liming, *Study on the Contract Law (Vol. 1)*, 154–155 (People's University Press, 2002).

[16] In western countries, freedom of contract was regarded to have embodied some of the cardinal principles of law. These principles were: (a) citizens enjoy a broad discretion to make contracts, (b) law routinely respects their choices of terms in contracts, and (c) the voluntariness of their choices is protected against coercion and fraud. See Patrick S. Atiyah, *The Rise and Fall of Freedom of Contract*, (Oxford University Press, 1979).

[17] See UNIDROIT, art. 1.1, *supra* note 3.

[18] See, Friedrich Kessler, Introduction: *Contract As a Principle of Order* from Peter Linzer, A Contracts Anthology, (Anderson Publishing Co., 2nd ed. 1995).

In order to cope with reality, Chinese scholars advocating for the freedom of contract argue that Article 4 of the Contract Law shall imply to include at least two basic notions. The first notion is that the consensual agreement of the parties shall have the effect superior to that of permissive provisions of law (*jus dispositivum*). This would mean that whenever there is an agreement, the agreement should control if no compulsory provision applies. Another situation where the parties' agreement must dominate is the one where the law permits "otherwise agreed by the parties".[19]

The second notion is the respect for the choice made by the parties concerning every aspect of a contract. The basic view is to stress that the choice should be made freely by the parties, not arranged or chosen for the parties by any authority or through administrative means. Therefore the free choice shall implicate that the natural person, legal person or other organizations have the right on the basis of their free will to determine whether to enter into the contract, to whom the contract is to be made, and what is to be contained in the contract.[20]

What is significant is that the provision of "making contract voluntarily" in Article 4 is interpreted by a quite number of Chinese legislators and scholars to grant to the parties the freedom of contract. Many of them have also made efforts to address Article 4 in a more specific way. To sum up, the freedom that the parties to a contract may have under the Contract Law is illustrated by a majority of Chinese scholars to include the following aspects:

- The freedom to decide to or not to enter into a contract. As a general principle, nobody including the administrative authority should interfere with or impose undue influence on the parties' contracting power. Although the contracting parties' right may still be limited, the limit shall be kept at a minimum level. Thus "no unit or individual may unlawfully interfere" under Article 4 is regarded as the key to the assurance of the freedom of contract;
- The freedom to determine with whom contract is to be made. In other words, a contracting party may freely decide who will be its counterpart. This is practically important in China because what may happen in reality, as it happened quite often in the past, is that in many cases the contract would be made between the parties through a "marriage" prearranged by relevant authorities. This arranged-marriage was also seen in certain company merger and acquisition cases.
- The freedom to determine the contents of the contract. Article 12 of the Contract Law provides that the contents of a contract shall be agreed upon by the parties. Article 12 also provides a list of 8 items as the general

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[19] See Wang Liming, *supra* note 15, at p. 155.

[20] See Sun Lihai, *supra* note 14, at p. 22.

contents of a contract.[21] Note that under the Contract Law, these items are not required items for a contract to be valid. Therefore, the contents may vary from contract to contract. In addition, Article 12 also allows the parties to use the model text of specific kind of contract. Moreover, under Article 61, the parties may make a supplementary agreement if there is no agreement in the contract regarding quality, price or remuneration and place of performance, etc. These items may also be determined from the context of relevant clauses of the contract or in accordance with transaction practices. Article 62 further provides in details how unclear items each may be determined if they could not be decided under Article 61.

- The freedom to choose the contract forms. The Contract Law seems to be flexible in the writing requirements. Under Article 10 of the Contract Law, a contract may be made in writing, orally or in other forms. Absent writing requirement stipulated by laws or administrative regulations, the parties may enter into a contract orally unless the parties agree to otherwise. According to Article 36, a contract, which should be concluded in writing as required but is not made in writing, shall be deemed as valid if one party has performed its principal obligations and the other party has received the performance. This performance doctrine also applies, under Article 37, to the contract that has been made in writing but not signed or stamped before the performance begins.
- The freedom to modify or rescind a contract. Article 77 of the Contract Law provides that the parties may modify a contract by consent through negotiation. The parties may also rescind a contract the same way in accordance with Article 93. The right of rescission under Article 93 may be provided by the parties in the contract or a separate agreement. The conditions under which a contract may be rescinded are also subject to the agreement of the parties.
- The freedom to decide what remedy or relief to be sought when one party breaches the contract. In accordance with Article 107, if one party to a contract fails to perform the contract obligations or its performance fails to satisfy the terms of the contract, the party shall bear such responsibilities for breach of contract as to continue to perform its obligation, to take remedial measures, or to compensate for loss. Article 107 is interpreted to allow the aggrieved party to choose the way for remedies, that is, the aggrieved party may ask for liquidated damage, may seek

[21] These 8 items are (a) title or name and domicile of the parties; (b) contract subject; (c) quantity; (d) quality; (e) price or remuneration; (f) time, place and method of performance; (g) liability for breach of contract, and (h) methods to solve disputes.

compensation, or may demand specific performance provided that such performance is permitted under the law.

- The freedom to choose the methods of settlement for disputes. There are 4 alternatives available to the parties for settling contractual disputes under Article 128 of the Contract Law, namely, conciliation, mediation, arbitration and litigation. The parties are encouraged, but not required, to seek conciliation or mediation as a first resort to the settlement of disputes. Litigation is available only if there is no arbitration agreement or the arbitration agreement is invalid. Once the parties agree to have arbitration, they will be bound by the arbitral award and no litigation is allowed concerning the same disputes.[22]

But there is the criticism that the Contact Law only has a limited recognition of freedom of contract because there are differences between "making contract voluntarily" and " freedom of contract".[23] Freedom of Contract focuses on maximum economic efficiency, and it promotes the parties' ability to exercise their full creative potential and to establish appropriate business relationships that possess all the specific nuances required in such relationships.[24] The fact is that although the parties may enter into a contract voluntarily, some interventions by the government often occur and the parties are still subject to certain unpredictable restraints. Therefore, many believe that to successfully defend against the unfair government interference, the parties right to the freedom of contract must be constantly emphasized and further respected.[25]

3. Limitations on Party Autonomy – Bird in Cage

Even if the freedom of contract is recognized in the Contract Law, the parties' right to freely enter into a contract is still limited. The language itself of Article 4 seems to impose at least two restrictions on the parties' contract

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[22] Under the Arbitration Law of China (1994), if the parties have concluded an arbitration agreement and one party initiates an action in a people's court, the people's court shall not take the case unless the arbitration agreement is void (Article 4). In addition, if, after the arbitration award is made, one party institutes a judicial proceeding in a people's court concerning the same disputes, the people's court shall not hear the case (Article 9).

[23] See Jiang Ping, *supra* note 10, at p. 5 and Yang Lixing, *supra* note 10, at p. 14.

[24] When invited to offer comments on the draft contract law, the legal committee of the American Chamber of Commerce (Beijing) stressed the importance of "freedom of contract" to be drafted into the general principles of the Contract Law.

[25] See Wang Liming, *supra* note 15 at p. 16.

making power: (1) a contract must be entered into according to law; and (2) only unlawful interference with contracting parties' freedom is prohibited.

It is true that the freedom of contract is not absolute in today's world and the parties' right to make a contract is subject to law and public policy. As professor John Calamari pointed, while the parties' power to contract as they please for lawful purposes remains a basic principle of contract law today, it is hemmed in by increasing legislative restrictions.[26] For example, a contract in violation of mandatory legal requirements will not be enforceable.

As far as the public policy is concerned, it generally has a twofold purpose. First, the public policy ground will serve as a proper means to assure that the bargaining between the parties has taken place in a manner compatible with the public interest in party autonomy in order to prevent unfairness and protect the parties from overreaching. This would require, among others, that the bargaining process not be abused by misleading or coercive conduct of any party. And second, the public policy consideration will be used as an appropriate sanction to discourage undesirable conduct, either by the parties or others, and to prevent an unsavory agreement.[27]

Therefore, in today's world, wherever the contract is made the party autonomy in making a contract is not unrestrictive. But in China, the limits on the right of the parties to make a contract clearly contain the "Chinese characteristics". A popular metaphor that may be used to describe the freedom of contract in China is the term "bird in cage".[28] It implies that parties to a contact may enjoy their freedom but the freedom may not go beyond the boundary prescribed by the government. The bird in cage model of the freedom of contract also seems consistent with the notion that the freedom is a granted right not an inherent one.

Although the freedom of contract may have different variation in different country, the bird in cage model is the typical product of Chinese reality. There are at least four unique characters in this model: (a) public ownership dominance, (b) supremacy of State interest, (c) limited choices of private parties, and (d) over-reaching government role. More specifically, the limitations as implicated in Article 4 on the freedom of contract could further be seen from the following aspects.

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[26] See John D. Calamari and Joseph M. Perillo, *The Law of Contracts* (4th ed), 5 (West Group 1998).

[27] See Farnsworth, *supra* note 1 at pp. 223–225, 321–323.

[28] As noted, 'bird in cage' is commonly used to describe the economy model promoted by the late Chinese leader Chen Yun who was famous as a primary designer of China's state economic plans (or planned economy). Under his economy model, the state plans functioned as a cage that defined the dimension of the business activities of all enterprises (the birds).

3.1. Legal Compliance

Limitations on freedom of contract are enhanced in China by the fact that a contract must comply with law and regulations both substantively and procedurally. The substantive compliance requires that the contents of a contract comfort to laws and regulations that are mandatory, and any violation of which would render the contract invalid or unenforceable. The procedural compliance imposes restrictions on the formality of a contract, which means that conclusion of a contract shall follow certain procedures stipulated by laws and regulations. In addition, for particular kinds of contracts, the state plan must be observed.

The most important provision in the Contract Law that restricts the parties' freedom in making a contract is Article 7. As a governing principle of legal compliance, Article 7 provides that in concluding and performing a contract, the parties shall abide by the laws and administrative regulations, and shall observe social ethics.[29] According to the Supreme People's Court, the law and administration regulations as referred in Article 7 not only mean those in contract areas but also include those in other areas that have the effect of limiting the parties' contract making power.[30] In addition, under Article 7, neither party may disrupt social-economic order or damage the public interest. Thus, Article 7 imposes limits on the party freedom of contract in two aspects: legal compliance and observance of social ethics.

The requirement of legal compliance was first provided in the 1986 Civil Code. But under the Civil Code, the parties to a contract are required not only to comply with the law but also to be bound by the State policy absent applicable law.[31] The Contract Law does not contain the policy compliance requirement because of the vast concerns about the uncertainty and unpredictability of the policy, particularly the concerns from foreign investors.[32] However, despite

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[29] For purposes of the Contract Law, laws refer to statutes or legal codes adopted by the National People's Congress and its Standing Committee, and administrative regulations are regulations issued by the State Council or approved to issue by the State Council. See Sun Lihai, *supra* note 14, at pp. 27–28.

[30] A typical example is the "Consumer Interest Protection Law", which imposes upon the manufactures or business operator restrictions in their dealing with consumers.

[31] Under Article 6 of the Civil Code, civil activities must comfort to the law, and where there are no relevant provisions in the law, the State policies shall be observed.

[32] A significant issue concerning policy is transparency. Since the policies in many cases are addressed in the "internal documents" or "red letterhead documents" of the government and may be changed at any time without notice, with regard to the parties to a contract, the possible impacts of the policies on their business transactions or operations are totally unpredictable and unmanageable.

the deletion of the policy requirement in the Contract Law, one should not underestimate potential influence of the government policies on contractual activities. Still, it remains questionable whether the parties may effectively protect themselves from the policy interference.

As to observance of social ethics, it was originated from the Civil Code.[33] But neither the Contract Law nor the Civil Code has defined the social ethics. In many cases, the issues of social ethics are addressed together with the social public order. It basically aimed at giving the judges discretionary power to adjudicate cases in the way that would best help promote the good moral standard and fair practices.

3.2. State Plan Mandate

As noted, the parties' contract-making power may be affected by the State mandatory task or State purchasing order under Article 38 of the Contract Law. Although China has been moving from planned economy to a market-oriented economy, the State still retains direct control over pillar industries or products essential to the nation's economy. In contrast to the past when contracts were under the absolute control of the government, the control now is being carried out through the State mandatory task or State purchasing order.

Companies or enterprises that receive the State mandatory task or the State purchase order are required to make contracts to implement the task or order, and the contracts are made between those companies or enterprises are the contracts between the users and the suppliers. It is clear in the Contract Law that a contract may not be enforceable if it is in violation of the State mandatory task or the State purchasing order. But, what seems problematical here is the extent to which the parties may seek judicial remedies when breach of contract concerning the State mandatory task or the State purchasing order occurs.[34]

3.3. Administrative Supervision

The administrative supervision of contract is unique in China. Rested mainly with the administrations of industry and commerce (AIC) as well as other relevant government agencies (RGA),[35] the administrative supervision is essentially the administrative interference with the parties' contractual rights. Before the

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[33] Article 7 of the Civil Code requires that civil activities defer to social ethics.

[34] In the past, all disputes involving the State mandatory plan related contracts were adjudicated primarily by administrative departments in charge other than a competent court.

[35] Generally, the RGA contains planning departments, construction administrations, supervising authorities of enterprises, departments in charge of exclusive trades, and real estate administrations. See *A Practical Guidance of the Contract Law of China,* pp. 126–127.

Contract Law was adopted, the AIC and the RGA had a broad administrative power to supervise contracts.[36] The Contract Law, however, seems to put limits on the exercise of such power. According to Article 127 of the Contract Law, the contract supervision of the AIC and the RGA is to deal with illegal conducts that are committed under color of contract to endanger and harm the State and public interests.[37]

Obviously, the primary purpose of Article 127 is to help protect the State interests in maintaining the economic order and social stability of the nation. The parties whose conducts are found to have caused harm to the state interest will face administrative penalty consisting of fine and/or revocation of business license. But the Contract Law contains no provisions with regard to how the administrative supervision shall be conducted and what the boundaries of the supervision are. Therefore, many are concerned about the overreaching of the administrative supervision due to the lack of distinction between the supervision and interference.

In practice, the administrative supervision also includes issuance of the model contracts, verification of contract, inspection of contract performance, administrative mediation of contractual disputes, as well as administrative sanction against illegal conduct involving contracts.[38] The model contracts are normally drafted and issued jointly by the AIC and the RGA to be used as the guidance in helping the parties draft their contracts. As far as international contracts are concerned, the Ministry of Commerce (MOC – formerly MOFTEC) also provides a set of model contracts for the parties to choose.[39] Under Article 12 of the Contract Law, parties may conclude a contract with reference to the model text of each kind of contract. Hence, the use of model contracts, though not mandatory, is strongly encouraged in practice.

The contract verification is the means by which the AIC and/or the RGA review the truthfulness and legality of the contract upon the application of the parties. Both the AIC and the RGA are in favor of the contract verification because from their point of view, the verification would help prevent contract fraud or sham contract, and would also increase evidential effect of existence of the contract. But what seems troublesome is the status of the verification. From the context of the Contract Law, the verification is not required in order

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[36] Under 1981 Economic Contract Law, AIC and RGA at county or higher level had authority to supervise economic contracts.

[37] Article 127 of the Contract Law further provides that if crime is committed, criminal responsibility shall be imposed.

[38] See Sun Lihai, "Explanation", *supra* note 6 at pp. 201–213.

[39] The MOFTEC was renamed as "MOC" (Ministry of Commerce) in March 2003 as a result of the restructuring of the central government.

for a contract to be valid, and it is not even an element in the contract making process.

On the other hand, since the verification gives the AIC and the RGA the power to review the substance of the contract (namely the contents), it then may cause uncertainty about effectiveness of the contract because the contract may be found irregular, for which the validity of the contract might be challenged. The question is whether the contract shall take effect upon the parties' signature (assume no government approval is required) or it will not really come into force until it is verified. Moreover, it is unclear what the parties' remedies would be if the AIC and the RGA make mistakes in the verification.

A derivative function of the administrative supervision is the administrative mediation of the contract disputes. The mediation could be conducted by the AIC or by the superior authority of the parties involved. Most cases in which an administrative mediation is called involve the disputes between state-owned enterprises, particularly when the State purchasing orders are at issue. Also as indicated, the administrative supervision may end up with sanctions against the party or parties for their wrongdoing. The sanctions generally include warning, fine, confiscation of illegal gains, expropriation of part or all of goods and/or deposit, as well as revocation of business license.

3.4. Government Approval and Other Special Requirements

For certain kinds of contracts in China, government approval is required or other special requirements must be met before the contracts become effective. Approval is the mechanism through which the contracts are under the screening of the government authorities, and it normally consists of two steps, namely review (examination) and approval. During the review, the reviewing authority will look into the contents and formality of the contract and see if they are in compliance with applicable laws and regulations. The approval will depend on the favorable result of the review. Therefore, the review is actually the basis for approval. In other words, no approval will be granted if a contract fails to pass the review.

At present, there are a number of contracts for which the government approval must be obtained. The most striking example is the contract involving foreign investments such as joint venture contract. In accordance with Article 3 of Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (as revised in 1990), the joint venture agreement, contract and articles of association shall be subject to review and approval by the state competent department in charge of foreign economic relations and trade. Similarly, under the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Venture Law (1988), agreement and contract reached by the parties to the joint venture will not take effect until they are reviewed and approved by competent authorities.

In addition, according to Regulations on Administration of Contract for Introduction of Technology (1985), contract entered into by and between recipient and supplier for introduction of technology shall be submitted for review and approval to the MOC or any other agency authorized by the MOC. The requirements of government review and approval also apply to contracts concerning exploitation of offshore petroleum resources in cooperation with foreign enterprises, transfer of patent right by Chinese enterprise or individual, first time import of pharmaceutics, as well as transfer of right of land use.

It is necessary to note that if the review and approval are required, a contract will not have effect unless and until the approval is obtained. Under Article 44 of the Contract Law, the contract subject to approval as provided by laws or regulations shall become effective upon approval. According to the Supreme People's Court, any contract for which the State approval is required shall be invalid without obtaining the approval.[40]

In addition, if a contract is subject to government review and approval, the requirement of review and approval are extended to the modification and assignment of the contract. It is provided in Articles 77 and 87 of the Contract Law that if the government approval is required for a contract, modification or assignment of such contract will equally require an approval from the approving authority or other designated authority in order for the modification or assignment to become valid and enforceable.

Moreover, for certain type of contract, an approval is also needed when the contract is to be terminated. For example, under Article 14 of the Chinese-Foreign Equity Joint Venture Law (as amended 2001), in case of heavy losses, failure of a party to perform its obligation under the contract and the article of association, or *force majeure* etc., the parties to the joint venture may terminate the contract by agreement, but the agreement for termination of the contract shall be submitted to the approving authorities for approval.

Other special requirements for a contract to be valid include registration, filing, as well as filing and recording. Registration refers to the process of registering contract or agreement with authorized government agencies before the contract or agreement takes effect. For example, under Article 10 of the Patent Law of China, transfer of patent application right or patent right shall be made thought a written contract, and the contract shall take effect only after the contract is registered with, and announced to the public, by the competent patent bureau. Registration also applies to contracts concerning Chinese-foreign

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[40] See Supreme People's Court "Answers to Several Questions Concerning Application of Foreign Economic Contract Law" (October 19, 1987), and Supreme People's Court "Opinions on Questions Regarding Implementation of Economic Contract Law" (September 17, 1984).

joint exploration of China's mineral resources.[41] For any of these contracts, the Chinese contractual party must register it with relevant registration authority after the contract is signed.

Filing is required when the parties enter into a license agreement for trademark use under the trademark law and regulations. A filing with approving authority is also needed when the parties terminate the foreign contract that has been approved by the government. Additionally, contracts in relation to private dwelling house rentals shall be filed with local real estate administration authority, and contracts for hiring of temporary works need to be filed with local labor department.

Filing and recording apply to contracts that involve real estate. According to the Law of Real Estate Administration, contracts for sale of real property shall be filed with and recorded at the real estate administration department of county level or higher. Without filing and recording, a real property contract will have no any effect, even though the contract has been agreed upon and executed by the parties.

[41] See Provisional Methods of Registration and Administration of Mineral Resources Exploration.

Chapter III
Enforceability of Contracts

As discussed, a contract in China refers to an agreement made by the parties, which is deemed to be something more than just a promise. The Contract Law, therefore, is purposed to enforce the agreement, and the focus is on the voluntary undertakings of the two parties who make the contract, not simply on the promise made by one party or the other. From this point of view, the Contract Law premises the contract on the mutual assent of the parties.

In Chinese contract literature, attempt has been made to draw a line between promise and contract albeit similarities between these two. In one respect, a contract represents social institution of agreement making, while a promise is seen as a social institution of a more informal kind. In other respect, a contract, once made, is backed by the coercive power of the state. A promise, however, is supported by moral argument and the enforceability of it is based on "an artificial virtue" or morality.[1]

To say that a contract is an agreement should not imply that every agreement could be enforced as a contract. Take a closer look at the definition of contract in the Contract Law, it is not difficult to conclude that a contract shall contain at least two requirements: first, it is a voluntary undertaking by parties of equal status, and second, it is purposed to create, modify or terminate relations of

[1] See, T. M. Scanlon, *Promises and Contracts*, from Peter Benson, The Theory of Contract Law, 86–117 (Cambridge University Press) (2001).

civil rights and obligations. Therefore, for an agreement to be enforced as a contract, the agreement must meet these requirements. To be more specific, the agreement shall not involve any improper activity such as criminal offences and shall not be used to serve any illegal purpose. In addition, for purposes of the Contract Law, the agreement shall not be the one that deals with relationship concerning personal status such as marriage, adoption or guardianship.[2]

With regard to the enforceability of a contract, Article 8 specifically provides that when a contract is established in accordance with the law, it shall be legally binding on the parties. Article 8 further provides that the parties shall perform their perspective obligations in accordance with the terms of the contract and neither party may unilaterally modify or rescind the contract without the other party's consent. It is stressed under Article 8 that the contract established according to law shall be under the protection of law.

For an agreement to be enforceable, there are several factors that are addressed in the Contract Law. First of all, an agreement is enforceable if it is made by mutual assent of the parties. As noted, the mutuality between the parties is considered as the essence of a contract in China. Under the Contract Law, it is required that a contract be made on the basis of equality and voluntariness. Article 13 of the Contract Law explicitly provides that the parties shall conclude a contract in the form of an offer and acceptance. Article 25 further provides that a contract is concluded when the acceptance becomes effective. It is important to bear in mind that in China to be enforceable a contract need not be supported by consideration.

Secondly, an agreement may be enforced if one party has performed its principal contractual obligations and the other party has accepted the performance. The doctrine of performance of principal obligations is adopted in the Contract Law to apply to the situation where there is defect in contract formality. In accordance with the Contract Law, in order for a contract to be valid, the required formality must be observed. Under Article 10, a contract may be formed in written, oral or other forms. If the laws and administrative regulations require a contract to be concluded in written form, or the parties agree to use written form, the contract shall be made in writing. Article 32 provides that if the contract is made in writing, it shall be concluded when both parties sign or affix a seal on it. However, according to Articles 36 and 37, if a contract is not made in writing as required by law, regulation or the parties, nor is the written form singed or affixed with a seal, but one party has performed its principal obligations and the other party has accepted the performance, the contract shall be deemed concluded and enforceable.

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[2] Under Article 2 of the Contract Law, agreements involving marriage, adoption and guardianship shall apply the provisions of other laws.

Thirdly, an agreement may become enforceable if one party reasonably relies on the other party's words or conduct and changes its position accordingly. Although the concept of "promissory estoppel" does no exist in Chinese contract law tradition, the approach of reasonable reliance has been incorporated into the Contract Law. Under Article 19 (2), an offer may not be revoked, if the offeree has reasons to rely on the offer as being irrevocable and has made preparation for the fulfillment of the contract.[3] Thus, in this situation, if the offeree accepts the offer, a contract then is concluded regardless of the offeror's intention or action to revoke the offer, provided that all other requirements for a contract to be valid have been met. Obviously, as provided in Article 19 (2), the reasonable reliance test requires two key elements: (a) reasonable belief and (b) performance preparation.

However, with regard to the questions such as why a contract shall be enforced and which agreement shall be enforceable and which will not, the great emphasis is on the validity of contract and principles set forth in the Contract Law. Validity of contract deals with the legal effect of a contract concluded by the parties. Because an agreement is enforceable only if it is made in accordance with the law, the Contract Law is primarily concerned with what agreement the law will enforce or recognize as creating, modifying or terminating civil rights and obligations.

Therefore, for a contract to be binding, it must be legally valid. In this regard, unlike the previous contract legislations, the Contract Law differentiates the contract that is formed from the contract that is valid under the law. According to Chinese contract scholars, conclusion of a contract does not necessarily mean that the contract becomes valid because the validity may be affected by other factors such as conditions for a contract to take effect. Also the validity of contract would affect the formation of a contract, which will be further discussed in the relevant chapter of this book.

The basic principles that govern contract are provided in the General Provisions of the Contract Law. These principles are deemed to serve as the foundations of the contract law legislation and as the guidance for the application of the Contract Law. In addition, the principles are generally used as the benchmark that determines the rules of bargaining in making a contract and the standard by which the terms of a contract are to be interpreted.[4] It is

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[3] Interestingly, Article 19 (2) at first glance looks similar to § 87 (2) of Restatement (Second) of Contracts. But the latter has a clear focus on offeror while the former is concerned about offeree. § 87 (2) provides: "An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice."

[4] See Wang Liming*, Study on Contract Law*, Vol. I, 137–139 (People's University Press, 2002).

a common characteristic and also a tradition in the Chinese legislation that each law contains certain stated principles, and the principles are treated as the fundamental guidelines or norms imbedded the law. It is believed in China that under the umbrella of the principles, every provision in the law is integrated with all other provisions in the law, by which the unity of the law will well be preserved. In this connection, the contract principles in China, though a bit abstract, are compulsory and must be followed by the parties.

As provided in the Contract Law, the principles that govern contract include "equality", "voluntariness", "fairness", "good faith", "legality", and "observance of contract obligations". In the context of the Contract Law, enforceability of the contract would depend on whether these principles have been observed. Thus, a contract will be invalid if it is found in violation of any of the principles stated in the Contract Law. Additionally, when hearing contract law cases, the people's courts often base their decision on the contract principles. Simply put, the contract principles are the authoritative legal sources for the courts to make decisions.

1. *Obligatio* and Contract Obligations

As pointed out, contract in China is regarded as one of the causes for *obligatio* to arise. In fact, the law of *obligatio* and the law of property are the twins of civil legislation in the countries with the civil law tradition. A distinctive feature of *obligatio* is that it gives one party the right to make a claim against the other party. In essence, an *obligatio* creates both rights and obligations, under which one party (obligee) is entitled for its own benefit or a third party's interest to ask the other party to do or not to do something, and the other party (obligor) is obligated to perform accordingly to satisfy the obligee's request. Arising from the *obligatio*, the right of obligee consists of three parts: demand for performance including payment; right to receive performance including payment; and request for protection when obligor defaults in fulfillment of its obligations.

Because contract triggers *obligatio*, an obligee-obligor relationship between the contracting parties will be established when contract is made. The parties to a contract are obligee and obligor respectively to each other because during the course of performance of the contract the position of parties changes. For example, Party A entered into a contract with Party B where Party A agreed to provide computer software services to Party B for which Party B agreed to pay Party A. From services point of view, Party B is obligee and Party A is obligor. However, after the services are done, Party A becomes obligee to receive the payment and Party B changes to obligor to make payment. Under Article 84 of the Civil Code, the *obligatio* represents a special relationship of rights and obligations established between the parties concerned, either by the

agreed terms of a contract or according to the provisions of law.[5] The party entitled to the rights shall be the obligee and the party assuming the obligations shall be the obligor.

The law of *obligatio* is aimed at providing legal assurance that rights will be protected and obligations will be performed, and for this reason, the law of *obligatio* is also called the law of obligations. According to Article 84 of the Civil Code, the obligee shall have the right to demand obligor to fulfill his or her obligations as specified by the contract or under the provisions of law.[6] Thus, fulfillment of *obligatio* is nothing but proper and complete performance of obligations arising from contract or other legal grounds for purposes of realizing the rights of obligee. In China, a very common proposition then is that to enforce a valid contract is to meet the requirements of *obligatio*.[7] Article 106 of the Civil Code explicitly provides that citizens and legal persons who breach a contract or fail to fulfill other obligations shall bear civil liability.

Scholars in China focus much of their attention on the performance of obligations. They argue that in order to satisfy *obligatio*, performance of obligations shall follow three basic rules. The first rule is actual performance rule, which requires that parties fulfill their obligations for the agreed subject matter, and should not arbitrarily substitute the subject matter with liquidated damage or equivalent unless the actual performance is excused. In addition, under the actual performance rule, one party who fails to perform his obligations shall be obligated to continue actually performing, and the other party has the right to demand him to do the same.[8]

The second rule is proper performance rule. The thrust of the proper performance rule is that in addition to the agreed subject matter, the parties under mutual obligations are required to make performance under agreed terms and conditions. To the extent that obligations are satisfied, the proper performance rule serves as a safeguard to the performance so that it will be made as agreed with regard to essential aspects of the performance such as quantity, quality, time, place, as well as formality. Since it is often the case that a contract may not actually be performed properly, the proper performance is held as the standard to determine whether and to what extent there has been a breach of obligation.[9]

The third rule is described as cooperative performance rule. The rule is intended to encourage parties in an obligee-obligor relationship to perform

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[5] See 1986 Civil Code, art. 84.

[6] See *id*.

[7] See Tong Rou, et al, *Chinese Civil Law*, 299–303 (Law Press, 1998); Zhang Guangxing, *General Introduction to the Law of Obligations*, 15–17 (Law Press, 1997); Wang Jiafu, *Obligatio in Civil Law*, 128–130 (Law Presss, 1998).

[8] See Tong Rou, *id*, at p. 310.

[9] See *id*, at p. 311.

their mutual obligations in a cooperative way. Also, under the cooperative performance rule, the parties owe to each other the mitigation duty. Article 114 of the Civil Code is regarded to have underscored the cooperative performance rule as applied to contract. According to Article 114, if one party is suffering losses caused by the other party's breach of contract, the grieved party shall take prompt measures to prevent the losses from aggregating; if the grieved party does not promptly take any measures, which cause the losses to increase, he shall not have the right to claim compensation for the increased losses.

2. Equality and Voluntariness

Equality deals with status of parties in any given civil relation. Under the civil law tradition, the law of *obligatio* is classified as private law where parties are in a horizontal relationship, as opposed to public law where the relation of parties involved is vertical and in most cases is between state and its citizens. This tradition is deeply implanted in Chinese civil law legislation and typically reflected in the Civil Code. Article 2 of the Civil Code unequivocally provides that the civil law of the People's Republic of China regulates both property and personal relationships between citizens, between legal persons, and between citizens and legal persons. And Article 3 of the Civil Code sets forth as a principle that parties to a civil activity shall have equal status.

The Contract Law follows the Civil Code, emphasizing that contract is an agreement made between the parties having equal status. Article 3 of the Contract Law further stresses the principle of equality by providing that the parties to a contract are equal in legal status (which means that they are conducting civil activities on an equal footing). In the meantime, Article 3 of the Contract Law specifically prohibits any party from imposing its will on the other party. In the Contract Law, the principle of equality is premised on the notion that equality in the legal status is the prerequisite for parties to engage each other in a contract. This notion is also coherent to the doctrine of horizontal relationship as referred to civil activities.

In China, the equal legal status test that applies to all civil activities is described to embrace three principal requirements. The first one is that parties to a civil activity shall have equal capacity for civil rights. This would mean that each party in civil activities, regardless of his or her age, religion, position or physical or economic condition, shall have the same capacity for civil rights and such rights shall not be deprived of or restricted by anybody. Under Article 10 of the Civil Code, all citizens are equal as regards their capacity for civil rights.[10]

[10] See the 1986 Civil Code, art. 10.

Article 10 applies to non-Chinese citizen through Article 8 of the Civil Code, which provides that the stipulations of this Law as applied to citizens shall apply to foreigners and stateless person within the territory of the People's Republic of China except as otherwise provided by law.[11]

The second requirement concerns equal treatment of the parties in civil activities. The key point is that different parties, when dealing with each other in civil areas, shall have equal legal status and be treated equally. Speaking literally, if the State or a state agency or state-owned enterprise is engaged in a civil activity, it shall be deemed as the same as a regular civil party, and shall have no any privilege over any other party. Interestingly, according to a quite number of Chinese contract law scholars, the equal treatment requirement is derived from the belief that all men are equal before the law.[12] An important implication of the equal treatment is to promote fair dealing and to prevent administrative abuse of power.[13]

The third requirement embodied in the equal legal status aims at equality in negotiation, which means that parties in civil activities equally have the rights to determine their affairs by negotiation and the negotiation is conducted in the way that no party may overtake the will of the other. The equal negotiation requirement not only applies to the creation of civil relationship between relevant parties, but also governs modification and termination of such relationship. The whole idea is to try to ensure that the parties will deal with each other fairly and freely.

The most significant features of equality are mutual benefit and mutual assent. In contracts, mutual benefit requires that parties to a contract enjoy their contractual rights respectively corresponding to their contractual obligations. In other words, no party may be entitled to contractual rights disproportionately more than its contractual obligations by taking the advantage of the other party. And mutual assent is to guarantee that the contracting parties have every opportunity to express their will freely.

Therefore, for purposes of the Contract Law, the principle of equality is essentially to mean that the parties are equal in their legal status no matter what their backgrounds or positions are in regard to making a contract between them, performing the contract as agreed, bearing contractual obligations, and assuming liability for breach of the contract. From this point of view, it may conclude that the stress on the equal status of the parties to a contract helps

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[11] See *id*., art. 8.

[12] See *id*., at p. 23.

[13] It is quite common in China that the State, a state agency, or state owned enterprise uses its position economically or politically to influence business activities, and in many cases such influence is excised through administrative means to downplay the role or status of other party involved.

further re-enforce the rule of "non-imposition of one party's will on the other" stated in Article 3 of the Contract Law.

At issue, however, is the government interest that a contract might affect. For example, in a contract between a private company and a state-owned enterprise, the private company may have difficulty in being treated the same as the state owned enterprise. It is particularly true when a local government interest is involved, and when the government has a clear preference to protect the state owned enterprises in which it has interest. Take remedies for instance, the private company might not have the same access to the remedies as the State owned enterprise would have because the government generally has the tendency to protect the State owned enterprise in whatever means the government may see fit.

The voluntariness essentially talks about the free will of the parties in making a contract and it primarily involves the self-determination power or autonomy of the parties. As explained, because of the concerns about being tainted by western ideology, the Contact Law is shy away from the term "freedom of contract", but instead sets forth as a principle the voluntariness in an attempt to safeguard the legitimate rights of the parties to a contract. Under Article 4 of the Contract Law, the principle of voluntariness basically contains two parts: the first part is about the rights of the parties to voluntarily enter into a contract within the limits of law, and the second part is to prohibit any unit or individual from unlawfully interfering with the contract.

3. Fairness and Good Faith

Article 5 of the Contact Law requires that parties to a contact abide by the principle of fairness in determining their respective rights and obligations. Article 4 of the Civil Code has a similar provision mandating that in civil activities the principle of fairness shall be observed. However, both the Civil Code and Contract Law do not define the fairness – perhaps for two reasons: first, it is difficult to square the meaning of the fairness, and second, it is better to let the courts to deal with this matter on a case by case basis.

But, in general, fairness is mainly concerned about the contents of the contract, and it is purposed to achieve a balance of rights and obligations between the parties. As advocated by Chinese scholars, the fairness has its root in the idea that the relation between the contractual parties shall be maintained to the extent that the rights and obligations are reasonably and justly allocated and shared. Specifically, the benefits a party has acquired shall proportionally match the obligations it has born.[14] It seems that the principle of fairness

[14] See Jiang Ping, *et al*, *A Detailed Explanation of the Contract Law of Law*, 6–7 (China University of Political Science and Law Press, 1999).

resemble the principle of equity although the concept of equity in China is not as popular as in western countries.

In judicial practices, the Chinese courts employ several tests in determining whether the fairness has been achieved. The first test is "obvious unfairness" rule. This rule is developed from Article 59 of the Civil Code. In accordance with Article 59, a party shall have the right to request a people's court or an arbitration institution to alter or rescind a civil act that is obviously unfair.[15] In general, unfairness would be obvious if it is found that a party has taken the advantage of the other party to cause the relation of rights and obligations clearly unbalanced in favor of the former.[16]

The second test is "reasonable allocation of risks" approach. Standing on the theory of market,[17] this approach regards each business transaction as consisting of both predicable and unpredictable risks. Fairness would require that the parties to a contract share the risks fairly and justly, though not necessarily equally. Therefore, it would constitute unfairness if a party takes more risks on a involuntary basis than the other party in their contract dealings. Under this test, what the court would look at in order to determine whether there is a violation of fairness is whether the possible risks are reasonably allocated between the parties.[18]

The Third test is called "fair distribution of rights and obligations" standard. In accordance with this standard, a party to a contract is required to bear the obligations proportionate to the rights it has or claims to have. A typical example to illustrate this standard is the matter concerning the validity of the disclaimer clause in a contract. In dealing with the effect of the disclaimer, the court will make a determination on whether the distribution of the rights and obligations between the parties would be unfairly affected by the disclaimer. Another example is the standard contract. The court will normally look into the standard contract against the provider of the contract, particularly in the case where the standard contract is simple a "take it or leave it" deal.[19]

Because the fairness principle is fundamental to the contract-based business transactions, some scholars in China view the principle of fairness as the principle of justice. They believe that a distinctive feature of the contract is the "exchange for equal value" and for the value to be exchanged equally the justice

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[15] See the 1986 Civil Code, art. 59.

[16] See Economic Trial Chamber of the Supreme People's Court, *Explanation and Application of Contract Law*, 28–29 (Xinghua Publishing Press, 1999).

[17] Market is the place where the risks and opportunities co-exist, and they are shared by the players.

[18] See Li Guoguang, *Explanation and Application of the Contract Law*, 28–33 (Xinhua Press, 1999).

[19] See Wang Liming, *Study in Contact Law*, supra note 4 at 181–186.

must be preserved in contracts. In its application, the principle of justice would require that the parties to a contract should treat, and deal with, each other fairly in both making and performing of the contract.[20]

Good Faith essentially embraces business ethics. Being a principle to govern civil act in China, good faith was first provided in the Civil Code in which it was termed as "honesty and credibility". The Contract Law follows the Civil Code and makes good faith a contract principle. Under Article 6 of the Contract Law, the parties to a contract shall observe the principle of honesty and credibility in exercising their rights and fulfilling their obligations. It is claimed that rooted in Confucian tradition, good faith has long been a moral norm in the Chinese society, represented by the popular dogma of "faithful to promise".

The Contract Law, however, makes no attempt to define the "good faith". In the United States, the good faith in Section 1–201 (19) is defined as "honesty in fact in the conduct or transaction concerned".[21] Chinese scholars view the UCC definition as "honest conduct" doctrine and criticize it as the lack of consideration of the interests of the parties because they believe that a major function of good faith is to maintain balanced the interest of parties and the interests of the parties and society.[22] Another American doctrine widely discussed in China is Professor Robert Summers' notion of "excluder". According to Professor Summers, the good faith is best left undefined and best understood as excluding activities that are deemed bad faith.[23] But this notion is deemed unpersuasive because a "non bad faith" does not necessarily mean a "good faith".

Under the tradition of Confucianism, good faith would implicate faithfulness, trustworthiness and honesty. Confucius had a strong belief that "people could not live without credibility" (*Min Bu Xin Bu Li*), which became a long lasting "gentleman rule" in Chinese history. Although scholars in China differ in how the good faith should be defined, it is generally interpreted to mean that in civil activities, people shall be honest to each other without abusing their rights and shall perform their obligations faithfully. In addition, in order to observe good faith principle, it is required to balance the interests between the parties and between the parties and society. In an effort to make the good faith more understandable, some Chinese scholars illustrate the good faith in the context of the Contract Law to contain the following aspects:

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[20] See *id*.

[21] See UCC, § 1–201(19).

[22] See Xu Guodong, *Concept and Historical Evolution of Good Faith Principle*, 4 Legal Research (1989).

[23] See Robert S. Summers, *the General Duty of Good Faith – Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810 (1982).

(a) During negotiations for a contract, the parties have the obligations to deal with each other truthfully and shall cooperate in their efforts to make the contract;
(b) After the contract is concluded, the parties shall take all necessary steps to prepare for the performance of the contract;
(c) When performing the contract, the parties shall each faithfully perform their contractual obligations, including assistance and notice necessary to the contract performance;
(d) After the contract is performed, the parties may have the obligation not to disclose the business secrets they obtained from each other during the contract period; and
(e) When a dispute arises out of a contract provision, the parties shall fairly and reasonably interpret the provision so that the mutual benefits of parties would be respected.[24]

In addition to Article 6, the Contract Law has two more articles that are directly related to the good faith principle. One is Article 42 under which a party shall be liable for damages if during the process of making a contract it performs any act that violates the principle of good faith and causes losses to the other party. The other one is Article 60, which requires that the parties observe the principle of good faith and fulfill the obligations of notification, assistance and confidentiality in accordance with the nature and purposes of the contract as well as the trade practices. The following case would help illustrate how the good faith principle is being interpreted and applied in the people's courts.

Wen Zaolun v. Guang Xi Movies Studio
and Guang Dong Full Stars Movie & TV Entertainment Inc.

Beijing High People's Court[25]

On September 20, 1999, Defendant Guangxi Movies Studio (Guang Xi Movies) and Defendant Guang Dong Full Stars Movie & TV Entertainment Inc. (Full Stars) entered into a contract to jointly make a 30-episode TV series drama named "No Other Alternatives". Under the contract, Full Stars would invest all funds for making the drama and would be responsible for setting up the production team. In addition, during the drama making process, Full Stars would be solely responsible for dealing with any disputes with a third party concerning copy rights and other economic interests without causing any liability to Guang Xi Movies. The responsibility of Guang Xi Movies mainly included the obtaining of government approval of the scripts of drama and related work. On this basis,

[24] See Jiang Ping, *supra* note 14, at p. 7.
[25] The case was reported in the First Civil Division of Beijing High People's Court, *"An In-depth Analysis of Beijing Civil Cases"*, (Law Press, 2003) at pp. 203–210.

the " 'No other Alternatives' Production Group" (Production Group) was formed under Guang Xi Movies Studio / Full Stars Movie & TV Entertainment Inc.

On November 8, 1999, the Production Group and Plaintiff signed an agreement under which Plaintiff agreed to play the male leading role in the drama. The term of the agreement was from October 25, 1999 to February 29, 2000, and the Plaintiff would be paid RMB 50,000 per episode or RMB 1,500,000 in total. The payment would be made in three installments: RMB 500,000 up front at the time of agreement, RMB 500,000 to be made 60 days after the agreement was signed, and RMB 500,000 to be made 14 days before the production ended.

Plaintiff was actually paid RMB 500,000 on September 14, 1999 for the role he would play in the drama. However, after the first ten episodes were completed, on December 7 Plaintiff felt sick and asked for a day leave. On the next day, Plaintiff visited doctor and was diagnosed to have proteinuria, which was a suspect of kidney disease. As a result, Plaintiff was advised to take rest for two weeks. On the same day, Plaintiff asked his assistant to give the Doctor's diagnosis to Li Baoguo, the director of production group. Li Baoguo then told Chen Zecheng, the drama director, that Plaintiff was sick and could not attend the drama filming. Under this circumstance, Chen Zecheng had to adjust the filming schedule.

Plaintiff then was absent from the drama filming for about two weeks. On December 21, 1999, the Production Group retained its lawyer to send a "lawyer's letter" to Plaintiff, stating that due to Plaintiff's uncooperative conduct, the Production Group had suffered heavy economic loss, and therefore, the Production Group had to terminate the agreement with Plaintiff and in the meantime reserved the right to hold Plaintiff liable for damages. Consequently, the Production Group did not make any further payment to Plaintiff.

In response, Plaintiff brought the lawsuit against both Guang Xi Movies and Full Stars. Plaintiff claimed that under the agreement, he was entitled to the payment of RMB 1,500,000, but was only paid RMB 500,000. To support his claim, Plaintiff argued that he played the first ten episodes and due to the overloaded filming work that caused him sick, he had to see the doctor, and that his sick leave from the drama filming was under the doctor's advice and was approved by director Chen Zecheng. Plaintiff then alleged that the Production Group's abrupt termination of the agreement without negotiating with him constituted a breach of contract, and therefore both Guang Xi Movies and Full Stars should be held liable for his economic damages of RMB 1,000,000, which would be his expected interest.

Guang Xi Movies moved to dismiss Plaintiff's action on the ground of its contract with Full Stars. Guang Xi Movies argued that since Full Stars would be solely responsible for dealing with any disputes between the Production Group and a third party, there would be nothing to do with Guang Xi Movies concerning the disputes between the Production Group and Plaintiff.

Full Stars argued that it paid Plaintiff RMB 500,000 under the contract, but Plaintiff did not perform his duties during his 15 days absence on personal health excuse without approval by the Production Group. Full Stars further argued that Plaintiff's notice of absence to the Production Group and his actual leave from the drama filming unequivocally demonstrated his inability to timely perform his obligations under the contract, and therefore the Production Group had the right to terminate the contract with him.

In addition, both Guang Xi Movies and Full Stars filed a joint counter claim against Plaintiff. They asserted that under the contract, Plaintiff would be with the Production Group daily for 4 months but his work would be no more than 12 hours a day, and therefore, he would not take any leave during the 4 months period. They argued that plaintiff's

absence from December 7 to December 21, 1999 constituted a breach of the contract, and the breach had caused great damages in the amount of RMB 1,471,030.22 to the Production Group, which included overhead expenses of RMB 283,175.22, Plaintiff substitute's cost of RMB 2,405, additional actor's cost of RMB 510,000, script revision cost of RMB 189,750, director's time extension compensation fee of RMB 207,000, and actors' time extension compensation fee of RMB 224,700.

The No. 2 Beijing Intermediate People's Court (trial court) found that Plaintiff's failure to perform the contract during December 8 to December 21, 1999 was caused by his illness, and he had informed the Production Group of his illness with doctor's diagnosis and asked for leave, to which the Production Group expressed no objection, and that after receiving Plaintiff's request for sick leave, the Production Group made adjustment to the drama filming schedule accordingly, and the schedule adjustment would serve as an indication of the Production Group's acknowledgement of Plaintiff's sick leave. The trial court then held that because of the Production Group's "no objection" and "acknowledgement", Plaintiff's sick leave should not be regarded as a breach of the contract. On this ground, the trial court dismissed Guang Xi Movies and Full Stars claim for damages against Plaintiff.

The trial court, however, was of opinion that although Plaintiff's sick leave did not constitute a breach of the contract, given that he was playing a leading role in the drama, whether he could continue playing his role was essential to the performance of the contract and to realizing the objective of the contract. The trial court therefore held that as a leading role, Plaintiff's absence for 14 days as well as the possibility of his continuing to take sick leave because of his "kidney disease" had made it uncertain whether he could play his role any more, and under this circumstance, it would be permissible for the Production Group to terminate the contract with Plaintiff in order to protect the Production Group's economic interest. For the reason that the Production Group's termination of the contract was not in breach of the contract, the trial court rejected Plaintiff's claims as well.

All parties involved in the case appealed to Beijing High People's Court (appellate court). The appellate court agrees to trial court's judgment on the ground that the trial court did not err in finding Plaintiff's sick leave not a breach of the contract under the good faith standard, and it is also reasonable to uphold the Production Group's termination of the contract for purposes of self-protection. The judgment below is then affirmed.

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The key issue in the *Wen Zaolun* case is whether Plaintiff's sick leave or the Production Group's termination of the contract would constitute a breach of the contract. According to the judge in the trial court, this case presented the following characteristics: (1) the circumstance on which the contract was based changed after the contract was made; (2) the change of the circumstance was unpredictable by the parties at the time the parties entered into the contract; (3) neither of the parties could be blamed for the change of the circumstance; and (4) it would be unfair to have the contract remain effective given the change of the circumstance.

If this case were tried before the Contract Law was adopted, the courts might base their judgment on *Rebus Sic Stantibus*, a contract doctrine that

allows a party to be excused from performance when a change in circumstances beyond the contracting parties' expectation and control frustrated the original basis of the contract so that the continuing performance would obviously render unfairness.[26] The Contract Law, however, does not adopt this doctrine because (1) there is no commonly accepted definition for *rebus sic stantibus*; and (2) it is very difficult, if not impossible, to draw a line between *rebus sic stantibus* and normal commercial risk. As a result, the courts would have to look into other doctrine.

Thus, when analyzing this case, the appellate court heavily relied on the "good faith" principle of Article 6 of the Contract Law. According to the judge who wrote the comments on this case, to determine whether there was a breach of the contract, what the court looked at included, among others, (a) whether Plaintiff had made the "sick leave" in good faith, and (b) whether the Production Group honestly believed that the happening of unexpected event would make its interest in jeopardy if the contract were not terminated. As to the court, it is important to make sure whether it would be fair to have parties to continue performing the contract.[27]

4. Legality and Public Interests

The enforceability of a contract also depends on whether the contract is in compliance with law and in consistence with social and public interests. Article 7 of the Contract Law mandates that the parties, in making and fulfilling the contract, abide by law and administrative regulations and respect social ethics, and may not disrupt the social-economic order nor impair social and public interests.[28] It is important to keep in mind that Article 7 of the Contract Law is significantly different from Articles 6 and 7 of the 1986 Civil Code. Under Article 6 of the Civil Code, civil activities must comply with the law; if there are no relevant provisions in the law, the state policies shall be observed.[29] Article 7 of the Civil Code also prohibits civil activities from undermining the state economic plans.[30]

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[26] This doctrine was upheld by the Supreme People's Court. In its letter of judicial instruction issued on March 6, 1992, the Supreme People's Court held that for purposes of the instant case, due to the chance in circumstances that could not be foreseen and prevented by the parties during the performance of the contract, it would be obviously unfair if defendant was asked to continue performing its obligations according to the original contract.

[27] See the First Civil Division of Beijing High People's Court, *"An In-depth Analysis of Beijing Civil Cases"*, *supra* note 25 at pp. 206–210.

[28] See the Contract Law, art. 7.

[29] See the 1986 Civil Code, art 6.

[30] See *id*., art 7.

Legal compliance involves legality of a contract. It is essential that the contents, goal as well as formality of a contract meet the requirements of law. Under Article 54 of the Civil Code, for a civil act to have legal effect, it must be "the lawful act of a citizen or legal person to establish, change or terminate civil rights and obligations."[31] Article 58 of the Civil Code further provides that a civil act shall be null and void if it violates the law or the public interest.[32] For the purposes of the Contract Law, the law would include both law and administrative regulations. According to the Law of Legislation of China, law refers to the statute promulgated by the National People's Congress and its Standing Committee, while administrative regulation is the rule or regulation adopted by the State Council or Ministries with the approval by the State Council.[33]

Two questions relevant to the legality of the contract need to be further addressed. The first question concerns the boundary of legality, which involves what would be deemed "unlawful" or "illegal" in determining the legality issue. In general, the legality is limited to non-violation of laws and regulations that are compulsory or mandatory. The mandatory law or regulations are those that the parties must apply. For example, under Article 40 of the Guaranty Law of China, in concluding a mortgage contract, the mortgagor and mortgagee shall not provide in their agreement that the ownership of mortgaged property shall be transferred to the creditor in case the mortgagee's claim is not satisfied after maturity of the debt.[34] Thus any agreement made to this effect would violate the legality requirement, and then would not be enforceable.

In addition, the legality should be determined under the national laws and regulation. On December 19, 1999, in order to help implement the Contract Law, the Supreme People's Court of China issued *An Explanation to Several Questions Concerning Application of the Contract Law of China.* According to the Supreme People's Court, after the Contract Law takes effect, when making the determination on whether a contract should be null and void, the people's courts shall apply the laws stipulated by the National People's Congress or the administrative regulations adopted by the State Council, and the determination may not be made under local laws or local administrative rules.[35]

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[31] See the 1986 Civil Code, art. 54

[32] See *id*., art. 58.

[33] The Law of Legislation of the People's Republic of Law was adopted on March 15, 2000 and effective on July 1, 2000.

[34] See the Guaranty Law of China, art. 40.

[35] See Supreme People's Court, *An Explanation to Several Questions Concerning Application of the Contract Law of China* (1999), available at http://www.law-lib.com/law/law-view.asp?id=70172.

The second question goes to the State policy. Under the 1986 Civil Code, the legality of a civil act would also include the compliance with the State policy. As briefly discussed in the previous chapter of this book, the policy problem is indeed highly controversial because on the one hand the policy is a useful device for the government to take action in the area where the law is unclear, and on the other hand, the policy would make the consequences of civil activities unpredictable and therefore uncertain.

There are two issues that are involved in policy, one of which is the issue of transparency. Since most policies in China take the form of internal document or speech of a leader, they are quite often not readily available to the general public. The other issue is the effect of policy. Especially when there is a conflict between the policy and the law, an immediate question would be which one controls. Although it seems to be true that the role of the State policy now is not as important as it used to be, the potential impact of the policy should definitely not be underestimated. Nevertheless, the Contract Law is generally regarded as being more rule-based than the Civil Code in this respect because the Contract Law, at least on its face, does not make the policy compliance a determinant for the validity of a contract.

Social public interest is generally understood in China to mean social morals and public order though it is not defined in either the Civil Code or the Contract Law. From the viewpoint of the people's courts, public interest provision is a general rule that is elastic in terms of its application, which would require an exercise of the judge's discretionary power. The question then is how and when this provision may be applied. One opinion is that because the public interest is a generally normative provision, it normally may not be directly used as the legal basis for a court to render its decision.[36] Another opinion argues that the purpose of the public interest provision is to allow the court to directly apply the public interest rule to nullify a contract if the contract is found to have damaged national or social interests or social morals, and there exists no relevant law that is readily applicable.[37]

Scholars from the Law Institute of Chinese Academy of Social Science (CASS) have made efforts to classify the social morals and public order into different categories. For example, according to Professor Liang Hui Xing at the CASS, the civil conduct that violates social morals and public order should include those that (a) damage national interest, (b) hamper family relations, (c) violate sexual morals, (d) violate or infringe human rights or human

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[36] See Economic Trial Chamber of the Supreme People's Court, *Explanation and Application of Contract Law, supra* note 16 at pp. 43–44.

[37] See Su Haopeng, *Formation and Validity of Contract*, 69–70 (China Legal Publishing House, 1999).

dignity, (e) restrict economic or business activities, (f) violate fair competition, (g) commit illegal gambling, (g) infringe consumer interests, (h) violate labor protection, or (i) seek usurious profits.[38]

5. Observance of Contract

Article 8 of the Contract Law establishes a rule of observance of contract by stressing that a valid contract is binding and must be observed. Under Article 8, a legally established contract has legal binding force on the parties, and the parties shall fulfill their obligations as provided in the contract and may not unilaterally modify or rescind the contract.[39] Article 8 further provides that a contract that is legally made is under the protection of law.[40] The very purpose of Article 8 is to ensure the performance of the contractual obligations, which is based on the long-settled civil principle in China that an agreement, once legally made, shall be honored. The fundamental thrust of this rule is the contract maxim of *pacta sunt servanda,* meaning that agreements must be kept.

The binding effect of a contract is generalized in China to come from two important sources. The first source is the will of parties. Because the contract is an agreement made by the parties, when making the agreement the parties are willing and prepared to be bound by it. A prerequisite of the binding force, of course, is that the agreement is made freely. Put another way, in order for the contract to be performed as the parties have agreed, it is important that the parties are trustworthy to each other and abide by the agreement. The second source is the will of the State to facilitate the business transactions within the norms of law and regulations. A common view among Chinese scholars is that the law embraces moral imperatives, and for the sake of market order, it is in the strongest interest of the State that agreements are kept as promised by the parties – a moral standard that is enforced as a legal rule.[41]

In the context of the Contract Law, the binding effect of a contract contains the following aspects. First of all, the parties are required to properly and completely perform their obligations under the contract. In pursuit of the performance rule, the party not only has the duty to perform its own contractual

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[38] See Liang Huixing, *Market Economy and the Principles of Public Order and Good Morals*, in Treatise on Civil and Commercial Law (Vol. 1), 57 (Law Press, 1999).

[39] See the Contract Law, art. 8.

[40] See *id*.

[41] See Economic Trial Chamber of the Supreme People's Court, *Explanation and Application of Contract Law*, *supra* note 16 at p. 45.

obligation, but also has the right to demand the other party to perform under the contract. Secondly, after a contract is made, a party may not modify or rescind the contract without the other party's consent. If there exists a necessity for a change of the contract, the change shall be made through the negotiations between the parties. Thirdly, a party will be held liable if it fails to perform its contract obligations unless the non-performance is excused under the provisions of law. In case of breach of the contract, the party in breach may be compelled to continue performing or to pay for damages. And fourth, when dispute arises between the parties, the contract shall serve as the basis on which the dispute is to be resolved.[42]

Note that in Chinese contract law, there is a very popular term that is used to describe the effect of a contract. The term is known as "legally established" or *Yi Fa Cheng Li* in Chinese, which mean that a contract is formed according to the law. For a contract to be legally established, it must be a product of combination of both the will of the parties and the will of the State. In other words, the contract must be made voluntarily by the parties and in compliance with the law in all aspects, such as contents, formality, and purpose of the contract. It is also important that the parties who make the contract are subject to review (judicial or administrative) as well in light of legal compliance (e.g. the capacity of the party). Therefore, a logical conclusion is that only the legally established contract has a binding effect and is enforceable.

6. Pre-contractual Liability

Traditionally, the parties to a contract owe no contractual duties to each other unless the contract relationship between them has formed. This doctrinal wisdom came from the classic presumption that either contractual responsibility has arisen or the parties have no legal rights against each other at all.[43] However, during the contract negotiations the parties in many cases would have to disclose their business information to each other for purposes of making the contract. The problem then is how to protect the respective interest of the parties during the process of contract making, particularly when a party's interest is (or likely to) be damaged by the other party's improper conduct when there is no contract yet.

A dilemma created by the above problem is the tension between freedom of contract and imposition of pre-contractual liability. In common law countries, the courts were reluctant to impose any responsibility on the parties to

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[42] See Jiang Ping, *supra* note 14 at p. 8.

[43] See Hugh Collins, *The Law of Contact (2nd Ed),* 168 (Butterworths, 1993).

a contract without their consent. A major concern was that the acceptance of pre-contractual liability doctrine would diminish the basic value of the freedom to the contract.[44] As a result, the negligence liability in torts was then borrowed and applied to deal with the responsibilities arising from the stage prior to the formation of the contract.

In China, however, pre-contractual liability is accepted and provided as a special liability system that is employed to impose liability on the party who during contract negotiations violates good faith and causes the other party to suffer damages. In the general sense, the imposition of pre-contractual liability is intended to deal with the liability that may not be properly characterized as either a contract liability or tort liability. The sole purpose of imposition of the pre-contractual liability is to provide a legal protection to the parties during the course of their making a contract.

The initial provision concerning pre-contractual liability in the current Chinese law is Article 61 of the 1986 Civil Code. Under Article 61, after a civil act has been determined to be null and void or has been rescinded, a party who acquired property as a result of the act shall return it to the party who suffered a loss. The erring party shall compensate for the loss that it has caused to the other party. If both parties are at fault, they shall each bear their proper share of the responsibilities.[45] Strictly speaking, however, Article 61 does not seem to clearly state the pre-contractual liability because it does not directly deal with the liability that arises prior to the conclusion of a contract. It is highly arguable whether a contract that is later declared null and void or rescinded would necessarily mean that the contract has not been formed.

The Contract Law explicitly makes pre-contractual liability an important contract law system. Article 42 of the Contract Law provides that the party shall be liable for damages if the party is under one of the following circumstances during the course of making contract and thus causing losses to the other party: (a) disguising and pretending to conclude a contract and negotiating in bad faith; (b) concealing deliberately the important facts relating to the conclusion of the contract or providing deliberately false information; or (c) engaging in other acts violating the principle of good faith.[46] Under Article 42, the pre-contractual liability could be construed to mean the liability for damages caused by one party to the other during process of contract making, or in other words, the liability of the party at fault prior to the formation of a contract.

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[44] See Hugh Collins, *id*, at pp. 169–170.

[45] See the 1986 Civil Code, art. 61.

[46] The Contract Law, art. 42.

Indeed, what liability the parties may have in the pre-contract stage remains an open question. Article 42 seems too broad in terms of scope and contents, and ambiguity may exist in its actual application, particularly when the "catch-all provision" of Article 42 (c) is to be applied. Therefore, it appears that in order to overcome the possible ambiguity in Article 42, a further interpretation and judicial determination would be needed. Perhaps due to the concern that the application of Article 42 might be mishandled, the Research Office of the Standing Committee of the National People's Congress has attempted to summarize the pre-contractual liability that may trigger Article 42. According to the Research Office, under the existing laws and judicial practice in China, the pre-contractual liability based on "at fault" would refer to the following:

(a) The liability arising from arbitrary withdrawal of the offer, especially when the other party has relied on the offer;
(b) The damages caused by failure to fulfill notice obligation during the contract negotiation;
(c) Liability arising from infringement to the personal or property right of the other party as a result of failure to fulfill the obligation of protection during the contract negotiation;
(d) Liability arising out of the failure to make contract;
(e) Liability occurring when the contract is void due to the negligence of the parties;
(f) Liability arising from the rescission of the contract; or
(g) Liability arising from non-authorized representation of the agent.[47]

Similarly, Some contract scholars in China have also tried to define the scope of the pre-contract liability. According to Professor Wang Liming of People's University (or *Renmin* University), for example, the pre-contract liability would include the following obligations:

(a) Obligation not to withdraw an offer without due course;
(b) Obligation not to conceal material information such as the contracting party's financial situation as well as ability to perform the contract;
(c) Obligation to operate and provide necessary assistance;
(d) Obligation to be faithful;
(e) Obligation to keep secret all confidential information; and
(f) Obligation not to abuse the freedom to a contract.[48]

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[47] The Research Office of the General Office of the Standing Committee of the National People's Congress of China, Explanation and Application Guidance to the Contract Law of China, 50–52 (China Democracy and Legality publishing house, 1999).

[48] See Wang Liming, *Study on the Contract Law*, *supra* note 4 at pp. 312–313.

In addition, the imposition of pre-contractual liability under Article 42 would require four elements. First, in order for Article 42 to apply, there must be a breach of duties imposed by law prior to the conclusion of the contract. A distinctive feature of the pre-contractual liability is that the liability does not arise from the agreement between the parties, but rather it is created by the operation of law. Second, the breach has caused damages or losses to the other party. A difficult issue here is how to determine the losses. A majority of Chinese scholars take the position that the losses suffered by a party during the pre-contract stage is his reliance interest, which mainly refers to the costs incurred to him in reliance on the contract to be formed.[49] Third, there must exist fault, including intentional misconduct or negligence, for which a party could be blamed. The very fundamental standard in determining whether a party is at fault is whether the good faith principle has been violated. And forth, causation must present between the losses that are claimed and the fault of the liable party, which means that the losses the aggrieved party has suffered were necessarily caused by the fault of the other party.

The following case tells how a people's court determined the pre-contractual liability specifically. In this case, the trial court dismissed the plaintiff's claim for pre-contractual liability against defendant on the ground that plaintiff failed to fulfill its burden of proof that defendant was at fault.

Sichuan Yafeng Construction Engineering Company, Ltd.,
v.
Sichuan Green Pharmaceutical Technology Development, Inc.

Pengzhou City People's Court, Sichuan Province
Pengzhou Mingchu No. 511[50]

Plaintiff: Yafeng Construction Engineering Company, Ltd, Pengzhou City, Sichuan Province (hereinafter referred to as "Yafeng Company"), located in Bai Xian Jie Village, Longfeng Township of Pengzhou City;

Defendant: Sichuan Green Pharmaceutical Technology Development, Inc. (hereinafter referred to as "Green Pharmaceutical Company") whose principal business office is 10th Floor, International Plaza, 206 Chuncheng Jie, Chengdu City.

The facts of the case were as follows:

On April 6, 2001, plaintiff Yafeng Company attended the public bidding offered by defendant Green Pharmaceutical Company for the project of defendant's scientific

[49] See Wang Liming, *Introduction to the Contract Law and Case Analysis*, 84–85 (People's University Press, 2001).

[50] This case was reported in National Judicial College & China People's University School of Law, *An Overview of Trial Cases of China (Volume of Civil and Commercial Cases of 2004)*, 7–11 (People's Court Press & People's University Press, 2005).

research and quality testing building. After the bids contest, plaintiff was selected by the Bidding Evaluation Committee as the winner of the bid, and the result was also notarized by the Notary Public Office of Pengzhou City. A "Bid Winning Notice", numbered as 2001–019, was then issued to plaintiff by the Construction Bidding Management Office of Pengzhou City.

Although plaintiff received the Notice from the Bidding Evaluation Committee, defendant refused to sign a written contract with plaintiff for the reason that plaintiff was lack of legitimate bidding capacity and therefore was incapable to perform the contract. Plaintiff then brought the lawsuit against defendant for pre-contractual liability. Plaintiff claimed that defendant's refusal to sign the contract with plaintiff violated the principle of good faith during the contract making process for which defendant shall be held liable. Plaintiff asked the court to order defendant to pay the damage in the amount of RMB 8,000 plus all litigation costs.

Defendant moved to dismiss by arguing that at the time of bidding, plaintiff had no legal capacity for making the bid. Defendant further argued that the winner of the bid should be decided by defendant, and the winning notice should also be sent to the winner by defendant. According to defendant, it never agreed that plaintiff was the bid-winner, and therefore it had every right not to sign the contract with plaintiff. Defendant also asserted that since it did no do anything wrong in the process of the bidding, and there was no fault or negligence on the defendant side, plaintiff's claim on pre-contractual liability ground should be denied.

The court finds that there is no evidence to prove that the Bidding Evaluation Committee was authorized by the defendant to determine the winner of the bid. The court also finds that the Bid Winning Notice issued by the Construction Bidding Management Office of Pengzhou City was not endorsed by the defendant who made the invitation to bid.

Based on the facts found, the court is of opinion that plaintiff attended the bidding but did not win the bid. Invitation to bid and submission of a bid are a special means of making a contract. The public announcement of invitation to bid or notice of public auction is nothing more than invitation to offer. In the bidding process, the submission of the bid is an offer, and the confirmation of the bid winner is an acceptance. Since the acceptance will take effect upon receipt, there will be no effective contract between the parties involved until the winner receives the bid-winning confirmation. Therefore, the key issue whether a contract has been formed is whether the bidder has won the bid. Also the public bidding shall be conducted under the provisions of the Law of Public Bidding and Submission of Bids of China (Public Bidding Law).

In the instant case, plaintiff did not win the bid and therefore no contract was ever made between plaintiff and defendant. Then the whole issue is whether defendant did anything wrong during the bidding process for which defendant would be held liable pre-contractually. Plaintiff alleged that defendant violated the good faith principle and therefore should bear pre-contractual liability imposed by the law. The court holds that under Article 42 of the Contract Law of China, the pre-contractual liability provision will apply only if defendant during the course of contract making committed bad faith negotiation, fraud or other conducts violating the good faith principle.

Clearly the pre-contractual liability under the Contract Law of China is based on the principle of fault liability. Applying this principle to this case, three factors must be ascertained in order to hold defendant liable. The first factor is whether defendant has breached its pre-contractual obligations. According to the provisions of Articles 7, 40 and 45 of the Public Bidding Law, the administrative supervision department shall supervise the public bidding activities, and investigate and punish illegal conducts in the public bidding process under the law; The inviter of bids may decide the bid-winner according to the written evaluation report or recommendation of the bid evaluation committee or authorize

the committee to make the decision; After the bid-winner is determined, a notice of winning bid shall be issued by the inviter. Thus in this case, it is the defendant's right not to authorize the committee to directly determine the bid-winner, not to have plaintiff selected as the winner among all candidates, and not to verify and issue the notice of the winning-bid to plaintiff. On the other hand, plaintiff did not provide any evidence to prove that defendant had violated its pre-contractual obligations.

The second factor is whether defendant had any fault subjectively. Plaintiff failed to prove that there existed fault on defendant side such as intentionally concealing important information pertaining to the conclusion of contract or providing false information. Absent subjective fault, defendant shall bear no fault liability as imposed by the law.

The third factor concerns whether plaintiff had any reliance interest and lost such interest due to defendant's fault. Plaintiff claimed that it had suffered RMB 8,000. But the evidence in the form of receipts only proved that the actual cost incurred to plaintiff for its participating in the public bidding was RMB 2,700. Of the cost, only RMB 300 for the notary public fees may constitute a reliance interest, and all other fees were the normal cost directly associated with the bidding activities. By normal, it means that plaintiff did not believe that it would win the bid by spending such money. In addition, the cost was clearly stated in the public bidding documents as the one to be born by plaintiff.

Based on the above facts and analysis, it is concluded that plaintiff does not meet the three-factor requirement for imposing pre-contractual liability on defendant, and therefore its claim must be denied for lack of legal grounds and sufficient evidence.

The case is then dismissed.

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The interesting part of *Sichuan Yafeng* is that the court established a three-factor test for imposition of pre-contractual liability under Article 42 of the Contract Law. Thus, in order to hold defendant liable on the ground of pre-contractual liability, plaintiff must prove with sufficient evidence all of the following three factors: (1) defendant's violation of its pre-contractual obligations, (2) defendant's subjective fault, and (3) loss of plaintiff's reliance interest.

An important implication of this case is of course of the burden of proof. In the judicial proceeding, to impose pre-contractual liability, it is imperative that the claiming party produces evidence. Under Article 64 of Civil Procedure Law of China (1991), it is the duty of a party to a civil action to provide evidence in support of his allegations. According to the Supreme People's Court, the party to a civil action is responsible for providing evidence to prove the facts on which his claim stands, if there is no evidence or the evidence is not sufficient to prove the facts, the party who has the burden of proof shall bear the adverse consequences,[51] meaning that a judgment will be entered against him.

[51] On April 1, 2002, the Supreme People's Court adopted the Several Rules of Evidence Concerning Civil Litigation. For general information about the Evidence Rules, see Mo Zhang, *Burden of Proof: Developments in Modern Chinese Evidence Rules*, 10 Tulsa J. Comp. & Int'l (2003).

Additionally, with regard to the pre-contractual liability, a relevant provision is Article 43 that applies to business secrets. In accordance with Article 43, neither party may disclose or inappropriately exploit business secrets obtained in the making of a contract regardless of whether the contract is formed or not.[52] If a party discloses or inappropriately exploits the said business secrets and consequently causes losses to the other party, the party shall be held liable for the losses. But the Contract Law contains no definition about what would constitute the business secrets. Therefore, in application of Article 43, a cross application of other law would be sought in order to make a determination on business secrets. A frequently cited provision in this regard is Article 10 of Unfair Competition Law,[53] under which the business secrets are defined to refer to any technology information or business operation information that meet the following four tests: (a) it is unknown to the public, (b) the owner of the business secrets has taken measures to keep it secret, (c) it could bring about economic benefits to the owner, and (d) it has practical utility.[54]

[52] See the Contract Law, art. 43.

[53] The Unfair Competition Law of China was adopted on September 2, 1993, effective December 1, 1993.

[54] In order to implement the Unfair Competition Law, on November 23, 1995, The State Administration of Industry and Commerce issued "The Several Rules about Prohibition of Conducts Infringing Business Secrets". Under the Rules, "not known to the public" means that the information may not be obtained directly from public channels; "to bring about economic benefit and having practical utility" imply that the information in question has the definite applicability and could provide actual or potential economic benefits or competitive advantages; "secret-keeping measures" include the signing of security agreement, the establishing of security system as well as other reasonable security measures; "technology or business operation information" consists of information containing design, program, recipe, production workmanship, production method, management know-how, customer list, sources of goods, production and marketing strategy, base amount of bid as well as the contents of bidding document.

Chapter IV
Formation of Contracts

Under Article 13 of the Contract Law, when making a contract, the parties shall take the form of offer and acceptance. As we discussed in Chapter II, a contract in China need not to be supported by a consideration and what really matters is the mutual assent of the parties. In order to achieve the mutual assent, it is essential that the parties have a meeting of minds through the negotiations on a voluntary basis. And the meeting of minds, as represented by an agreement between the parties, is to be realized in the form of offer and acceptance.

It is interesting to note that although the Contact Law is not the first contract legislation in the modern China, it is the first time that offer and acceptance are provided in the law. However, it is important to remind that for certain types of contracts in China government approval is required, and in these cases, the contract, though being formed, would not take effect prior to obtaining the approval from the government. Article 44 of the Contract Law contains the provisions that specifically deal with the formation and legal effect of a contract. According to Article 44, a contract legally formed shall take effect upon the formation of the contract. But if government approval or registration is required, the contract will become effective only after the completion of the approval or registration.[1]

[1] The Contract Law, art. 44.

1. Offer

In Article 14 of the Contract Law, an offer is defined as "a manifestation of an intent showing the desire to enter into a contract with others." Thus, there are two elements that an offer must contain: a manifestation of intent and desire to make a contact with others. In addition, to constitute an offer, the intent so manifested must meet the two requirements set forth in Article 14: (a) the contents shall be concrete and definite and (b) the offeror shall be bound by his manifestation of the intent upon acceptance by an offeree.[2]

For purposes of making an offer, the intent of offeror may be expressed either orally or in writing. It is unclear under the Contract Law whether the intent could also be inferred from the conduct of the offeror, but according to the scholarly interpretation, in the absence of express intent, such intent could be presumed though the offeror's conduct in light of the usage of transactions.[3] In other words, if it could be reasonably believed from the offeror's conduct that the offeror has the intent to make a contract, a contractual obligation may arise upon effective acceptance by the other party.

In the west, there exist both subjective and objective tests for determining the intent. The subjective test focuses on the actual intent of the parties, while the objective test relies on the outward manifestation of a party's intent. Simply put, the difference between the two tests is that under the subjective test, what really matters is what was intended rather than what a party reasonably believed was said and done.[4] Literally, there are no such tests in China, but it seems that the Contract Law has made the actual intent an essential element of an offer because it stresses the "desire to enter into a contract with others."

Chinese scholars have been debating on to whom the offer should be made. The center of the debate is whether the offer must be made to a specific (or identified) person. One opinion is that since an offer indicates the offeror's intent to make a contract, the offer should be made to the specific person with whom the offeror wishes to deal, or otherwise it should not be deemed as an offer. The opposite opinion takes the view that the offeree may not have to be specific because in a market economy where the fair competition is the goal to achieve, an offer should not necessarily be limited to the specific person.[5]

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[2] See *id*., art. 14.

[3] See Wang Liming, *Study on the Contract Law (Vol. I)*, 206–207 (People's University Press, 2002).

[4] See Robert Scott and Jody Kraus, *Contract Law and Theory* (3rd Ed), 238–239 (LexisNexis, 2002).

[5] See Wang Liming, *supra* note 3, at p. 208.

Loosely speaking, the Contract Law does not require that an offer be made to specific person. The majority opinion, nevertheless, is in favor of the "specific person" doctrine though the specific person may not necessarily be just one person. According to the majority, the reason why the offeree must be specific is that unless the offeree is specific it will hardly predict who would be the intended person to whom the offer is made. On the other hand, if an offer is allowed to be made to a non-specific person, it may result in a dilemma in which the offeror would face multi contracts because it is very likely that the acceptance is made by several non-specific persons of whom the offeror may not even know.[6]

Further it is also argued that provision of offer in the Contract Law shall be construed with reference to Article 14 of the 1980 United Nations Convention on Contracts for the International Sale of Goods (CISG).[7] Under Article 14(1) of the CISG, a proposal for concluding a contract addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. Article 14(2) explicitly provides that a proposal other than one addressed to one or more specific persons is to be considered merely as an invitation to make offers, unless the contrary is clearly indicated by the person making the proposal.[8]

In addition, the Contract Law does not specify what would constitute "concrete and definite" contents that an offer must contain. In general, an offer would be considered concrete if it embraces the very basic items that are sufficient to form the contract. To determine whether an offer is definite would depend on how a reasonable person with general knowledge related to the specific industry or products would think. In other words, an offer would be deemed definite if the contents of the offer could be ascertained under the standard of ordinary person. According to some Chinese scholars, the "concrete and definite" would mean that the contents of an offer are clear enough to make the offeree understand not only the offeror's true intent, but also the major terms that would be contained in the contract to be concluded.[9]

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[6] See Wang Liming, *id* at pp. 208–209.

[7] See Zhou Xiaoyan & Geyi, *Comparative Analysis on the Contract Law of the People's Republic of China*, 49–50 (China Foreign Economic Relations and Trade Publishing House, 2003).

[8] See United Nations Convention on Contracts for the International Sale of Goods (1980), *O.R*. 178–190; *Docy. Hist*. 766–778.

[9] See Jiang Ping, *Detailed Explanation to Contract Law of China*, 14–15 (China University of Political Science and Law Publishing House, 1999).

1.1. Offer and Invitation for Offer

We have already noted that an offer is "a manifestation of intent". But not every manifestation of intent will constitute an offer. Thus it is important that in order to become an offer, the manifestation must be made to the effect that it is understood by other person that the intent so manifested is to ask for a deal making. If a manifestation of intent contains no clear indication to make a contract or it is simple to pass on business information or advertise products or services, the manifestation would not be considered as an offer.

A manifestation of intent that is not sufficient to be an offer is often labeled as an invitation for offer. The Contract Law has a special provision that explicitly involves invitation for offer. In Article 15 of the Contract Law an invitation for offer is defined as a manifestation of intent indicating the desire to receive offers from others. Article 15 further provides that price catalogs mailed or delivered, public notice of auction, invitation to bid, prospectus and commercial advertisements as such are invitations for offer.[10] But, it should be noted that Article 15 has made an exception to commercial advertisement. Although in general the commercial advertisement is not an offer, it shall be deemed as an offer under Article 15 if its contents conform to the provisions regarding offer, namely "concrete and definite".

A debatable question concerning advertisement is the advertisement for reward. In the context of the Contract Law, Article 15 covers only commercial advertisement. According to Advertisement Law of the People's Republic of China (1994), the commercial advertisements refer to those for which a commodity producer or service provides pays, and by which the same, through certain media or forms, directly or indirectly introduces his commodities to be sold or services to be provided.[11] Apparently, the advertisement for reward is not characterized as commercial one. Therefore, it becomes questionable as to what nature an advertisement for reward would have and what effect it will produce.

The debate on the advertisement for a reward divides Chinese contract scholars into two groups. One group argues that an advertisement for reward is an offer because it is made to the public to ask for performance as requested. Under this argument, to perform what the reward is set for will constitute an acceptance and a contractual relationship will be established when the performance sought by the reward is complete. But what seems unclear is

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[10] See the Contract Law, art. 15.

[11] See Article 2 of Advertisement Law of the People's Republic of China. The Advertisement Law was adopted on October 27, 1994 and took effect February 1, 1995.

whether it is essential that the offeree complete performance with the knowledge of the offer in order to receive the reward.[12]

The other group disagrees. They argue that the contract theory of "mutual consent" does not apply to the advertisement for reward. Scholars in this group believe that a reward advertisement is not an offer but a unilateral conduct by which the advertiser makes request to the general public for specific performance. Under the unilateral conduct doctrine, once the advertisement for reward is made, the advertiser shall be bound by the advertisement regardless of the performer's actual knowledge of the advertisement. In addition, since the advertisement for reward is not an offer, no acceptance is required. Therefore, the advertisement for reward may not be withdrawn after it is made and whoever completes the required performance will be entitled to the reward.[13]

The following case is illustrative as to how the reward advertisement is dealt with in the people's courts.

Li Min v. Zhu Jinhua and Li Shao Hua

Tian Jin Intermediate People's Court, 1984, reported in the Gazette of the Supreme People's Court, II – 1995[14]

On March 30, 1983, defendants Zhu Jinhua and Li Shao Hua went to Tian Jin Peace Theater for a movie. After the movie, Zhu Jinhua left behind in the seat his briefcase that contained the document for the delivery of a car and other items worth RMB 800,000. Zhu Jinhua was asked by defendant Li Shaohua to arrange for the delivery of the car on behalf of Luo Yang Electric Company in He Nan Province. Plaintiff found the briefcase in the theater. After the theater was empty and no body came back to claim the lost briefcase, plaintiff took it and had it kept in the custody of Wang Jia Ping who was a policeman (named as third party in the case). When Zhu Jinhua realized that the briefcase was lost, he tried to retreat it but was unsuccessful.

On April 4 and 5, Defendant Zhu Jinhua published a notice in the "lost and found" section of "Today's Evening Paper" – a very popular newspaper in the City of Tian Jin. The same notice was also published in "Tian Jin Daily" on April 7. In the notice, Zhu Jinhua indicated respectively that whoever found and returned the briefcase would receive "a reward" and "significant award". But nothing happened after the notice was made. April 12, defendant Li Shaohua who came to Tianjin from He Nan, published another notice in his name in the "Today's Evening Paper" for the same purpose, in which the term "significant reward" was changed to "the reward of RMB 15,000 to the person who returns the lost briefcase within a week after the notice".

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[12] See Kong Xiangjun, *Difficult Cases in Contract Law, Analysis and Legal Research*, 93–94 (People's Court Publishing House, 2000).

[13] See *id*.

[14] See Gazette of the Supreme People's Court (1995).

In the evening on April 12, plaintiff Li Min saw Li Shaohua's notice in the newspaper. Li Min then told Wang Jiaping about the reward and asked him to contact Li Shaohua. On April 13, Wang Jiaping called Li Shaohua and two of them agreed to exchange the lost briefcase with the reward of RMB 15,000. When they met at the agreed place, however, defendants changed their mind and refused to give plaintiff RMB 15,000. After an unsuccessful mediation by a local police department, plaintiff brought the lawsuit against defendants for the RMB 15,000 in the People's Court of He Ping District.

In his claim, plaintiff asserted that defendants' failure to make payment of RMB 15,000 to plaintiff breached their obligation arising from the notice. Defendant Zhu Jinhua argued that because nobody responded to his notices in the newspapers on April 4, 5 and 7, they believed that the only way to make the finder of the lost briefcase to show up was to specify the reward amount. For that reason, Zhu Jinhua argued, the promise to give RMB 15,000 was not their true intent and therefore it was reasonable for them to refuse to pay. Defendant Li Shaohua contended that as a police, Wang Jiaping should not keep the lost briefcase in his custody, instead he should try to find the owner or turn the lost item over to relevant authority. Defendant Li Shaohua argued that since Wang Jiaping did not fulfill his duty, plaintiff's request for the reward should be denied.

The trial court found that the document for the delivery of a car and other items in the lost briefcase belonged to Luo Yang Electric Company and were the property of the Company. Based on its findings, the court held that plaintiffs' failure to find the owner or to turn the lost property over to the relevant authority was contrary to the public morals. According to the trial court, plaintiff should be able to find out who would be the owner of the lost property because the document and items in the briefcase clearly indicated the name of Luo Yang Electric Company. The trial court further held that as a policeman, Wang Jiahua should make all efforts to find the owner, and failure to do so constituted a violation of his duty. The trial court then denied plaintiff's claim on the grounds that the monetary reward in the notice was not the manifestation of true intent of the dependents, and therefore should be held to have no legal effect.

On appeal, the Intermediate People's Court of Tianjin reversed the trial court's judgment. The Intermediate Court was of opinion that the trial court's determination about "not the manifestation of defendants' true intent" was not supported by sufficient evidence and lacked legal authority. In its reversal, the Intermediate Court held that in accordance with the basic principle of the General Principles of Civil Law of China, defendants' notice indicating the reward and the money amount in the reward should be considered as legally valid.[15]

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It seemed that the Intermediate People's Court of Tian Jin in *Li Min* case based its decision on the contract theory. The rationale underlying its holding was that an advertisement for a reward, once made, would create a right-obligation relationship between the party who makes the advertisement and the party who performs duty requested by the advertisement, and as long as this relationship

[15] The case was settled between the parties under the auspice of the Intermediate Court. Under the settlement, Plaintiff received a onetime payment of RMB 8,000.

does not violate law in its formality and contents, it should be held valid. Therefore, if the reward advertiser fails to perform what he has offered in the reward advertisement, the offeree has the right to demand the offeror to perform. But the Court's holding seemingly had implied that the offeree's knowledge about the offer before the offeree's performance would be irrelevant.

Another noteworthy point is the distinction between offer and invitation for offer because sometimes the two are so closely intertwined that it is difficult to differentiate one from the other. For example, Article 16 of the Contract Law on the one hand regards commercial advertisement as an invitation for offer, and on the other hand intends to treat some commercial advertisements as offers by exceptions. This is a typical reflection of the open-ended nature of the matter as to what would be an offer and what would be an invitation for offer.

In an attempt to help draw a line between offer and invitation for offer, Chinese contract law scholars have been making efforts to provide a guideline doctrinally for this matter. Although scholars differ from each other in what should be included in the guideline, a general consensus is that the following tests should help tell offer from invitation for offer.[16]

The first test is the test of intent. Under this test, the question concerning an offer or an invitation for offer is to be determined by looking at the intent manifested by the party. If a party indicates, orally or in writing, that he will be bound by the terms and conditions in the proposal for a deal, the proposal shall constitute an offer. If however, the proposal only states the party's intent to invite other party to make an offer, the proposal is not an offer. Such intent may also be determined by the party's conduct or specific statement. For instance, if the phrase "for reference only" is being used, no offer is made. Similarly, when there is a statement saying that the proposal so made shall not be interpreted as an "offer," then there is no offer.

The second test is to look at whether the contents of a proposal contain major terms of a contract. If the proposal has specified the major terms, it would imply that the party making the proposal intends to enter into a contract with others, and the proposal is made to invite an acceptance. The reason is that an offer is aimed at making a contract with others while an invitation for offer only represents an early stage of preparation for negotiation. For purposes of making an offer, the major terms generally include name, price, quantity as well as specification of the object (e.g. a certain product).

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[16] Generally, see Wang Liming, *Study on the Contract Law, supra* note 1 at pp. 213–222; Kong Xiangjun, *Difficult Cases in Contract Law, Analysis and Legal Research, supra* note 10 at pp. 63–64; and Yang Lixin, *Implementation and Application of the Contract Law*, 39–40 (Jilin People's Publishing House, 1999).

However, even if the proposal contains the major terms, when the party making the proposal explicitly single out in the proposal that he will not be bound by the terms of the proposal or the terms need to be further negotiated, the proposal shall still not be regarded as an offer.

The third test concerns the usage of the transactions in the industry or the prior dealings between the parties. This test essentially focuses on the history of business dealings and the common practices in the said transactions. As an example illustrative of this test, assume that party A and party B have been engaged in purchasing certain product for quite a long time, and assume also that the specification and price of the product have never been changed during their previous dealings. Under this circumstance, if party A proposes to buy the same product from party B without stating specification and price but only the quantity amount, the party A's proposal will then be deemed as an offer though in normal situation it will not.

The forth test is the provision of law. If there is a clear indication in the law as to what should be considered as an invitation for offer, the law must be followed. For instance, in Article 15 of the Contract Law, price catalogs mailed or delivered, public notice of auction, invitation for bid, prospectus are explicitly listed as invitation for offer. Also, as a practical matter, the commercial advertisement is generally deemed as invitation for offer. But since the Contract Law is being criticized to be vague in what would constitute an exception to the commercial advertisement, scholars are trying to identify the situations under which invitation for offer could be more clearly defined. One proposal suggests that the manifestation of the intent made by the supplier through public advertisement or price catalog or display for purposes of supplying product or service at the special price shall be presumed as an offer.[17]

On June 1, 2003, the Supreme People's Court issued the "*Explanations to Several Questions Concerning the Application of Law in Adjudicating the Disputes Arising from the Contracts for Sales of Commercial Housing*".[18] In the *Explanations*, the Supreme People's Court attempts to classify as an offer certain advertisement for the sale of housing. According to the Supreme People's Court, the advertisement or advertising materials for sale of housing are generally the invitation for an offer. However, if the said advertisement or advertising materials contain specific and certain illustration and promises

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[17] See Liang Huixing, *Proposed Draft of the Civil Code of China*, Art. 845. 165 (Law Press, 2003).

[18] The term "commercial housing" (Shang Pin Fang) means the housing available for sale on the market, and most of them are residence housing. The housing in China used to be allocated by government or work units to the users but now the government or units allocated housing are being replaced by commercial housing.

made by the seller with regard to housing and related facilities within the scope of the for-sale residential housing development plan, and these illustration and promises will materially affect conclusion of the purchase contract of the housing as well as the purchase price, the advertisement or advertising materials shall be deemed as on offer. The Supreme People's Court further indicates that in this situation, the advertisement and advertising materials shall become the contents of the contract even if they are not included in the contract, and the party who fails to adhere with these contents shall be liable for breach of the contract.[19]

1.2. Legal Effect of Offer

An important issue is the time for an offer to take effect. Under the Contract Law, an offer, once made, will not become effective until it is received. It should be noted that with regard to an offer, a so-called "Arrival Rule" rather than "Mail Box" rule is applied in China.[20] Article 16 of the Contract Law provides that an offer becomes effective when it reaches the offeree.[21] A critical term that is used in this regard is "arrival time". In Chinese judicial practice, to determine the time of "arrival", the court will look at whether the offer has arrived in the place that is controllable by the offeree, not necessarily in the hand of the offeree.[22]

If, however, the offer is made through the means of data-telex, and the recipient has designated a specific system to receive the data-telex, the time of arrival of the offer will be the time when the data-telex enters into the system. But when no specific system is designated, the time when the data-telex first enters to any of the recipient's systems shall be deemed as the time of arrival.[23] It is commonly understood that the system as used in Article 16 refers to computer system though Article 16 does not specify it.

Under the Contract Law, when an offer takes effect, it may not be withdrawn, and the offeror would be bound by it unless offeror had indicated in advance that he would not be bound by the offer. But, if offeror does not

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[19] See the Supreme People's Court, the "*Explanations to Several Questions Concerning the Application of Law in Adjudicating the Disputes Arising from the Contracts for Sales of Commercial Housing*". Available at http://www.law-lib.com/law_view.asp?id=74535 (last visit December 20, 2003).

[20] "Mail Box" rule means that an offer will become effective at the time it is mailed, while under Arrival Rule the offer is effective upon its arrival at the offeree.

[21] See the Contract Law, art. 16.

[22] See Economic Law Chamber of the Supreme People's Court, *Contract Law Explanation and Application*, 116–117 (Xinghua Publishing Press) (1999).

[23] See Article 16 of the Contract Law.

intend to be bound by the offer, the offer so made would not be deemed as an offer but rather an invitation for offer. Thus it is required under Article 14 of the Contract Law that an offer shall indicate the offer's willingness to be bound by the offer upon acceptance by the offeree. In practice, however, it may not always be the case that the offeror's willingness to "be bound" is directly or unequivocally stated. Thus, the willingness in this regard may often be inferred from the words or terms used in the offer or the sincerity of offeror's intent to enter into the contract.

A related question is what effect of an offer would have pertaining to the offeree. The question actually involves who has the power to make an acceptance and when the acceptance should be made. In general, the acceptance must come from the person to whom the offer is made. In other words, the power to accept an offer may not be transferred unless such transfer is authorized or agreed to by the offeror. If offeree intends to accept the offer, the acceptance must be made within the valid period of the offer, which is either specified in the offer or within a reasonable period of time if no specific time is made in the offer.

A final point that should be made is whether an offeree has the obligation to notify the offeror if the offeree does not want to accept the offer. Normally, an offeree bears no obligation to send "non-acceptance" notice to the offeror. But problem may arise when offeree's silence is to be considered as an implied acceptance. Quite often, this situation occurs where the parties dealt with each other in the past in the way that the offeree always notified the offeror promptly if the offeree did not accept the offer. Under this circumstance, a notice would be required if offeree wants to turn down the offer, or otherwise the offeree's silence might be deemed as an acceptance.

1.3. Termination of Offer

An offer is terminated when it is effectively withdrawn or revoked, or it becomes void. The termination of an offer will result in the loss of the offeree's power to accept the offer. Thus an offer would have no effect for acceptance if it has been terminated. The Contract Law has special provisions that deal with how an offer is to be terminated.

1.3.1. *Withdrawal of Offer*

The Contract Law allows an offer to be withdrawn. Under Article 17, an offer may be withdrawn if the withdrawal notice reaches the offeree before or at the same time when the offer arrives.[24] Hence, the withdrawal of offers may only

[24] See the Contact Law, art. 17.

take place before the offer becomes effective. Because the Contract Law does not impose any restriction on the withdrawal of offers, it is generally understood that any offer could be withdrawn before the offeree receives it.

For an offer to be withdrawn, it is important that a notice is made timely. The key is that offeree receives the withdrawal notice before or at the same time the offer reaches the offeree. What is unclear, however, is whether the notice should be made in writing or it could be made orally, e.g. by telephone. The Contract Law contains no provision in this regard, but a commonly acceptable practice is that the withdrawal should be made in the way comparable to that the offer is made. To be more specific, if the offer is made in writing, the withdrawal notice shall also be made in writing; an oral notice of withdrawal may be acceptable if the offer is made orally.

1.3.2. *Revocation of Offer*

An offer may not be withdrawn after it takes effect, but it may be revoked. The revocation of an offer, if made effectively, will also terminate the offer. According to Article 18 of the Contract Law, an offer may be revoked if the revocation reaches the offeree before the offeree dispatched an acceptance of the offer to the offeror.[25] Therefore, a revocation may only occur after the offer becomes effective and before the acceptance is sent out. Once again, it is also questionable whether the revocation should be made in writing or it could be made orally, though the trend has been in favor of writing.

But, not every offer could be revoked. Pursuant to Article 19 of the Contract Law, an offer may not be revoked under either of the following two circumstances: (a) the offeror has specified a time limit for the acceptance, or has explicitly indicated in any other means that the offer is irrevocable; or (b) the offeree has reasons to rely on the offer as being irrevocable and has made preparation for the fulfillment of the contract.[26]

Article 19 (a) applies when there is a fixed time for the acceptance. Under Article 19 (a), the offeror may not revoke the offer before the time for acceptance expires. The reason is that by providing time limit for the acceptance the offeror has promised to the offeree that the offer would remain effective during the specified time period, and relied on such promise the offeree may decide to accept the offer at any time within the time limit. Therefore, it can logically be concluded that Article 19 (a) has its focus on the offeror's intent.

On the other hand, Article 19 (b) places the irrevocability of an offer on the belief of the offeree. There seem to have three conditions under which the Article 19 (b) exception could be triggered. The first condition is that the offer

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[25] See *id*. art. 18.

[26] See *id*., art. 19.

contains neither time limit for the acceptance nor any other means indicating that the offer is irrevocable. Or otherwise, it may fall within Article 19 (a). The second condition refers to the reasons for which the offeree believes that the offer is irrevocable. Although the Contract Law does not tell what would constitute the reasons, a general understanding is that if the words or phrases used in the offer or the previous dealings are so obvious or so persuasive that the offeree has a strong belief that the offer would not be revocable within a reasonable period of time, the reasons as such would then exist for purposes of Article 19 (b). The third condition is related to the second one, which is that in reliance on his belief, the offeree has done preparation work for the performance of the contract.

Note that Article 19 is regarded by some scholars in China as a legal source to impose pre-contractual liability upon the party who is at fault. The argument is that since the question concerning revocability of an offer arises in the negotiation stage for making a contract, an offer as being irrevocable does not necessarily mean that the offeror must fulfill his contractual obligations under the terms and conditions specified in the offer. Rather it would only be interpreted to mean that the offeror might be held liable for damages the offeree may have suffered due to the offeror's revoking of the offer. Therefore, the liability so imposed on the offeror is based on the offeror's fault in the preliminary contract making stage, i.e. breach of the promise not to revoke the offer.[27]

1.3.3. *Void Offer*

Under the Contract Law, an offer is terminated when the offer becomes null and void. According to Chinese scholars, a void offer would mean that the offer has lost its legal effect and is not binding to anyone. Further more, when an offer is null and void, the offeree's power to accept the offer would cease to be effective, and in this case therefore, even if an acceptance is timely made, it will not result in a contract.[28] To simplify, a void offer deprives the offeree of the power or ability to accept the offer.

Article 20 of the Contract Law specifies four situations under which the effect of an offer will be affected. As listed in Article 20, an offer becomes null and void if (a) a notice to reject the offer has reached the offeror; (b) the offeror has revoked the offer in accordance with the law; (c) the offeree fails to make an acceptance to the offer before the time for acceptance expires; or (d) the offeree has substantially altered the contents of the offer.[29]

Pursuant to Article 20 (a), an offer will be terminated if rejected by the offeree. The rejection occurs when the offeree does not accept the terms and

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[27] See Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3 at pp. 230–231.

[28] See *id*. at p. 231.

[29] See the Contract Law, art. 20.

conditions provided in the offer. Since Article 20 (a) requires a notice in case of rejection, it is generally believed that the rejection must be make expressly, though some argue that the offeree's "no-action" to the offer within the time limit for the acceptance may also constitute a rejection. And because under Article 20 (a), a rejection may take effect only after the rejection notice has reached the offeror, it implies that the rejection notice may be withdrawn before or at the same time the offeror receives the rejection notice.

Article 20 (b) essentially refers to the situation where an offer is revoked under Article 18 of the Contract Law. As discussed, Article 18 allows an offer to be revoked if the revocation is made before the acceptance notice is sent. Except for the restrictions stipulated in Article 19, an offer would become null and void when it is effectively revoked. Therefore, an acceptance that is made after the offer is revoked will not be the acceptance but a new offer. And when the "after revocation" acceptance becomes a new offer, the offeree will take the place of the offeror, and conversely the acceptance of the new offer will be up to the decision of the offeror.

In accordance with Article 20 (c), the lapse of time for acceptance may also cause an offer to become null and void, and the offer then is terminated. Article 20 (c) applies where the offer has specified the time limit for acceptance. For purposes of Article 20 (c), the offeree's failure to accept the offer within the allowed time period will be deemed as a rejection to the offer. Note, however, that since the Contract Law applies "Arrival Rule" to the acceptance, it is essential that the acceptance reach offeror before the expiration day of the offer. The implication of "Arrival Rule" to the acceptance will be further discussed later in this chapter.

The heart of Article 20 (d) is "material alteration". Under Article 20, an offer will be null and void if the offeree has materially changed the contents of the offer, and the change as such will result in the termination of the offer. The term "material alteration" is defined in Article 30 of the Contract Law as the change in the contract subject matter, quantity, quality, price or remuneration, time or place or method for performance, liability for breach of contract, or dispute settlement, etc. Hence, any change of the above items contained in an offer will make the offer null and void.

2. Acceptance

The concept of acceptance is provided in Article 21 of the Contract Law, which defines acceptance as "a manifestation of the offeree's assent to an offer".[30] As noted, the Contract Law is the first contract legislation in modern

[30] See *id*., art. 21.

China that contains the provisions of offer and acceptance though those two terms were actually used in practice for many years before the Contract Law was adopted. Indeed, the concepts of both offer and acceptance are not originated in China, but as provided in the Contract Law, they necessarily reflect some Chinese characteristics. First of all, offer and acceptance are based on the premise that contract is a mutual agreement. Secondly, acceptance, if valid, will result in the conclusion of a contract and no consideration is needed. Thirdly, for certain contracts, their effectiveness would be subject to administrative approval after acceptance.

2.1. Requirements for Acceptance

Yet, pursuant to Article 21, an acceptance is basically to mean that the offeree agrees to the terms and conditions contained in the offer and wants to enter into a contract with the offeror accordingly. Article 25 further provides that a contract is concluded at the time the acceptance takes place.[31] Under the Contract Law, however, for an acceptance to be effective, the following three requirements must be met.

The first requirement is "contents consistence" with the offer. As provided in Article 30 of the Contract Law, the consistence rule requires that the contents of the acceptance match the contents of the offer. Thus an alternation to the contents of an offer might affect the effect of the acceptance. However, in application of the consistence rule, the Contract Law divides the alternation into two categories: substantial alteration and non-substantial alteration. According to Article 30, any alteration that involves a change in "the subject matter of the contract, quantity, quality, price or remuneration, time or place or method for performance, liability for breach of contract, or dispute settlement" will be deemed as substantial alteration.[32] Otherwise the alteration will be non-substantial.

Under the consistence rule, if the offeree substantially alters the contents of the offer, the acceptance shall constitute a new offer. With regard to the consequences of non-substantial alteration, Article 31 explicitly provides that unless the offeror timely rejects or the offer clearly indicates that the acceptance may not alter the contents of the offer at all, the acceptance shall deemed valid in spite of the alteration, and the contents of the contract shall be those of the acceptance.[33] Therefore, unlike substantial alteration, non-substantial alteration to the offer does not necessarily affect the acceptance. To put it differently, what the consistence rule requires is substantial consistence.

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[31] See the Contract Law, art. 25.
[32] See *id*., art. 30.
[33] See *id*., art. 31.

The second requirement concerns "Arrival Rule". In accordance with Article 26, an acceptance becomes effective when the acceptance notice reaches the offeree. Once again, the Contract Law mandates that the acceptance arrive at the offeror in order for the acceptance to take effect. Under Article 22, the acceptance could be made either by notice or by act. In general the acceptance should be made through the means of notice, and the acceptance will take effect when the acceptance notice reaches the offeror. However, as provided in Article 26, if the transaction practice permits or the offer allows the acceptance to be made through an act, the performance of the act, e.g. to deliver the goods, will then constitute the acceptance. Article 26 further provides that if a contract is concluded in the form of data-telex, the arrival time for the acceptance will be the time when the data-telex enters the system.[34]

A timely arrival of acceptance notice is another important factor in the application of the "Arrival Rule". Article 23 of the Contract Law makes it prerequisite for an acceptance to take effect that an acceptance shall reaches the offeror within the time limit specified in the offer. Furthermore, in accordance with Article 23, if no time limit specified in the offer for acceptance, the arrival of the acceptance shall be determined in the following ways:

(a) If the offer is made orally, the acceptance shall be made promptly unless otherwise agreed upon by the parties; or
(b) If the offer is made in any other forms, the acceptance shall arrive within a reasonable period of time.[35]

Often, the reasonable period of time as provided in Article 23 (b) is to be determined according to industrial usages or transaction customs, previous dealings, or nature of the business. In addition, the method to communicate between the parties will also be considered. Thus, the channel that the parties have used to deliver the acceptance may become a relevant determinant as to what time period might be reasonable. Further it has been suggested that to determine a reasonable time period, the courts shall take into consideration the time length that the offeree would normally need to make a sound decision.[36]

Equally important is the time for an acceptance starts to run. Article 24 of the Contract Law provides three ways under which the time period for acceptance should be calculated. First of all, if the offer is made in the form of a letter or telegram, the time limit for acceptance commences from the date shown on the letter or from the date the telegram is handed in for dispatch. The "date

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[34] See *id*., art. 26.
[35] See *id*., art. 23.
[36] See Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3, at p. 233; See also Jing Ping, *Detailed Explanation to Contract Law of China, supra* note 9 at p. 20.

shown on the letter" refers to the time the letter of the offer is dated, and the "date for dispatch" means the time when the telegram is given to post office or other office engaged in telegram business for sending the telegram out, which is normally indicated in the official receipt of such office. Secondly, if the letter is not dated, the beginning time will be from the date as shown on the envelope that contains the offer. And thirdly, if the offer is made by means of instantaneous communications such as telephone or facsimile, the time limit for acceptance starts at the moment the offer reaches the offeree, meaning the moment at which the offeree answers the phone or receives the fax.

The third requirement for acceptance is that the acceptance must be made by the offeree to the offeror. This requirement is derived from the definition of the acceptance contained in Article 21 of the Contract Law. Since the acceptance is the manifestation of the offeree's assent to the offer, it must be made by the offeree. Of course, the acceptance may not have to be made by the offeree personally. It may be made by the authorized agent of the offeree. On the other hand, the acceptance may not necessarily be made by just one offeree. An acceptance could be made by several offerees if the offer is made to more than one specified persons. If, however, the acceptance is made by a third party – a non-intended offeree, it will be regarded as an offer.

Some contract scholars in China also suggest that the acceptance should comply with the format required by the offer. They argue that although under Article 22 of the Contract Law, an acceptance should in general take the form of notice unless otherwise allowed by business usages or indicated in the offer to be made by act, the way the notice is sent to offeror is subject to the requirement of the offer. For example, if the offer states that the acceptance shall be made through telegram, a mailed acceptance may then not be deemed acceptable. Therefore, a failure to follow the format specified in the offer for acceptance may render the acceptance void.[37]

From a reading of the Contract Law, it is questionable whether an acceptance could be implied. The Contract Law, while defining the acceptance as "a manifestation of offeree's assent to the offer", is unclear as to whether the manifestation could be inferred from the conduct – active or passive act of the offeree. More precisely, there is no readily answer to the question whether the offeree's acceptance to an offer could be manifested by silence. Interestingly, in its "*Opinions (Provisional) on the Questions Concerning Implementation of the General Principles of Civil Law of People's Republic of China*," the Supreme People's Court divided silence in the context of civil conducts into act-attached silence and non-act silence. According Article 66 of the Opinions, when one party makes to the other party certain claims of civil rights, and the

[37] See Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3 at pp. 236–238.

other party makes no expression through either language or words but takes certain acts purposing to acknowledge the claim, the implied acceptance could then be ascertained. The silence to which no act is attached, however, may be deemed as implied assent only if provided by laws or agreed upon by the parties.[38]

During the drafting of the Contract Law, acceptance by silence was expressly excluded from the early drafts. For example, under Article 21 (b) of the Draft Contract Law published in August 1998 for the comments from the general public, acceptance must be made in the express form and silence or non-act shall not constitute an acceptance. This provision was later deleted from the final draft because of the concerns that it might not be practical to eliminate the possibility of silence as an acceptance.[39] Therefore, in Article 22 of the Contract Law, it is provided that an acceptance may be made in the form of notice or by way of act. In judicial practice, the people's courts generally recognize acceptance by silence if it can be proved that the parties have specifically agreed upon or business usages allow.[40]

2.2. Withdrawal of Acceptance

Keep in mind that in China the "Mail Box" rule does not apply to either offer or acceptance. Thus, since the acceptance may not become effective until it reaches the offeror, it then may be withdrawn before becoming effective. In Article 27 of the Contract Law, the withdrawal of an acceptance is permitted and should be made through the means of notice. However, in order for a withdrawal of acceptance to be valid, Article 27 makes it mandatory that the withdrawal notice reach the offeror before or at the same time when the acceptance notice reaches the offeror.[41]

In pursuit of Article 27 therefore, the withdrawal of an acceptance may be held valid under two circumstances: (a) the withdrawal notice reaches the offeror before the acceptance arrives, or (b) both the withdrawal notice and the acceptance notice reach the offoror at the same time. In both cases, the time factor is critical, which in fact is a matter of burden of proof. It is particularly true that in the second situation, the party claiming an effective withdrawal

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[38] See Supreme People's Court, *Opinions (Provisional) on the Questions Concerning Implementation of the General Principles of Civil Law of the People's Republic of China* (1988).

[39] There are several situations in which an acceptance might be made by silence: (1) agreed upon by the parties in advance; (2) previous dealings or transaction customs; (3) provided by laws.

[40] See the Economic Law Chamber of the Supreme People's Court, *the Contract Law Explanation and Application, supra* note 22 at pp. 131–135.

[41] See the Contract Law, art. 27.

must prove that the withdrawal notice arrives at the offeror at the same time when the acceptance arrives.

2.3. Late Acceptance

As noted, under Article 20 (c) of the Contract Law, an offer may become void if no acceptance is made within the time limit specified in the offer. There are two situations in which no acceptance is made before the time for acceptance expires. One situation is that the offeree does not agree to the terms and conditions in the offer and has no desire to enter into the contract with the offeror. Then there will never be an acceptance. The other situation is that for some reasons the offeree makes no acceptance before the expiration of the acceptance time, but an acceptance is made afterwards. The acceptance that is made after the time for acceptance runs out is termed as "late acceptance".

It is unarguable that when an acceptance is made late it would then up to the offeror to decide the fate of the acceptance. The offeror may choose to deem it as a valid acceptance or otherwise the late acceptance will be considered as a new offer. The Contract Law also adopts the "up-to-offeror" approach in dealing with the late acceptance, but requires a timely notice to inform the offeree of the offeror's decision if the offeror wants to take the late acceptance. Under Article 28, if the offeree makes an acceptance beyond the time limit for acceptance, the acceptance shall be a new offer unless the offeror notifies the offeree promptly that the acceptance is effective.[42]

Thus, the implication of Article 28 is that the late acceptance shall have no effect for the purpose of making the contract unless the offeror accepts the late acceptance and timely informs the offeree of the effectiveness of it. In this respect, the late acceptance on the one hand may still be regarded as acceptance and its effect is subject to the offeror's cognizance; and on the other hand, the late acceptance may become a new offer and the offeror may decide whether to accept within a reasonable period of time or to reject. In the words of many Chinese scholars, Article 28 of the Contract Law actually grants the offeror an option to deem the late acceptance as if it was made timely or to treat it as a new offer.[43]

2.4. Late Arrival of Acceptance

As indicated, under the Contract Law an acceptance will not take effect until it arrives at the offeror. The late arrival of acceptance, however, is different

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[42] See the Contract Law, art. 28.

[43] See the Economic Law Chamber of the Supreme People's Court, *the Contract Law Explanation and Application, supra* note 15 at p. 242.

from late acceptance, and it occurs when the offeree made the acceptance within the time limit for acceptance, but the acceptance reached the offeror after the acceptance deadline. In an attempt to separate this situation from the late acceptance, the Contract Law recognizes the effectiveness of the late arrived acceptance with an exception that the offeror clearly indicates otherwise.

Article 29 of the Contract Law specifically deals with the acceptance that arrives late. Under Article 29, if the offeree dispatches the acceptance within the time limit and under normal circumstances the acceptance could reach the offeror, but due to other reasons the acceptance arrives beyond the time limit, the acceptance shall be effective unless the offeror informs the offeree promptly that the acceptance is not acceptable because it exceeds the time allowed.[44] Obviously, an acceptance that was timely sent but arrived late will generally be assumed to be effective absent offeror's rejection.

However, Article 29 offers no definition as to what would be the "normal circumstances" and what would constitute "other reasons" that cause the delay of the arrival of the acceptance. As a practical matter, the general understanding in the people's courts is that the "normal circumstances" should be those that are commonly acceptable under the customs or usages of the business dealings or particular industry. The determination of the "normal circumstances" will of course largely depend on the evidence provided for that purpose. With regard to "other reasons," although a case-by-case analysis might also be needed, they should be something that could not be blamed as the offeree's fault and usually would not happen (e.g. severe weather prevents the post office from delivering the mail timely).[45]

2.5. Acceptance and Conclusion of Contract

A very common notion under the Contract Law is that the conclusion (meaning formation) of a contract is dependent on the effectiveness of the acceptance. According to Article 25, a contract is concluded when acceptance becomes effective. In light of the Contract Law, the conclusion of contract means that the parties have reached a mutual assent, which demonstrates that the parties have agreed on the terms and conditions of the contract. The conclusion of the contract may also serve as an indicator of the beginning of the contractual rights and obligations between the parties. Basically there are two factors that affect the effectiveness of acceptance. These two factors are the time and place.

In an attempt to clearly address the time of contract, the Contract Law focuses on the way in which a contract is concluded. In addition to Article 26

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[44] See the Contract Law, art. 29.

[45] See Economic Law Chamber of the Supreme People's Court, the *Contract Law Explanation and Application, supra* note 22 at p. 149.

that provides the "arrival rule" for acceptance to take effect, Article 32 further stipulates that when a contract is made in writing, the contract is concluded at the time both parties sign or affix a seal on it.[46] Although Article 32 does not specify which one controls if the signature and seal are made at different times, the general rule is the doctrine of "first in time". Moreover, under Article 33, if the contract is concluded in the form of a letter or data-telex, etc., a party may request to sign a letter of confirmation.[47] Under this circumstance, the contract is concluded when the confirmation letter is signed.

With regard to the place of conclusion of contract, it is provided in a more specific way in the Contract Law because the place of conclusion of contract is regarded as an essential element that would affect the matters of jurisdiction (and choice of law in foreign cases) concerning the contract disputes. First of all, Article 34 adopts a general principle that the place where the acceptance takes effect is the place of conclusion of contract. Secondly, Article 34 contains a special provision stating that when the contract is concluded in the form of data-telex, the main business place of the recipient shall be the place of conclusion of contract, and if there is no main business place the recipient's habitual residence shall be considered as the place of conclusion of contract. Article 34 also permits the choice made by the parties if the parties have agreed otherwise as to the place of conclusion of contract.[48] And thirdly, in accordance with Article 35, if the contract is made in writing, the place where both parties sign or affix a seal shall be the place where the contract is concluded.[49]

Indeed, Article 34 of the Contract Law provides how the place of conclusion of a contract is to be determined pertaining to the particular way that the contract is concluded. But it should kept in mind that Article 34 provision is

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[46] See the Contract Law, art. 32.

[47] See *id*., art. 33.

[48] See *id*., art. 34.

[49] Note that the Contract does not define the terms "Main Business Place" and "Habitual Residence". In the Civil Code (1986), the term "Domicile" rather than "Main Business Place" is used for business entity. Under Article 39 of the Civil Code, the domicile of a business entity (generally phrased as legal person) is the place where its main administrative office is located. It is then unclear whether the main administrative office could be deemed as the main business place. As far as a citizen (natural person) is concerned, Article 15 of the Civil Code provides that the domicile of a citizen shall be the place where his residence is registered, and if his habitual residence differs from his domicile, his habitual residence shall be regarded as his domicile. According to the Supreme Court's interpretation, the habitual residence of a citizen is the place where he has lived consecutively for more than one year after being away from his domicile [Article 9 of the Supreme Court's Opinions (Provisional) on Several Matters concerning Implementation and application of the General Principles of Civil Law of China (1988)].

regarded as a general rule. By "general", it means that if there is other provision in this regard in any specific law that is inconsistent with Article 34, the other provision shall prevail.

3. Conclusion of Contract and Effectiveness of Contract

Importantly, under the Contract Law, the conclusion of a contract does not necessarily mean that the contract would take effect. In China, conclusion of a contact and effectiveness of a contract are deemed as two different matters that stand separately to each other. From the viewpoint of Chinese contract scholars, the effectiveness of a contract refers to that a contract, upon meeting all requirements set forth by law to be effective, takes effect and becomes legally binding, while the conclusion of a contract only indicates that the parties have reached an agreement.[50] It is true that in general the contract will take effect upon its conclusion, but in many cases the effectiveness of the contract that is concluded would depend on other factors (e.g. approval). For this reason, the conclusion of contract and the effectiveness of the contract are provided separately in the different chapters of the Contract Law, and the purpose is to differentiate one from the other.

For example, under Article 44 of the Contract Law, a contract takes effective upon its conclusion. Article 44, however, also provides that if required by the law or administrative regulations, a contract is subject to approval or registration in order to be effective, the effectiveness of the contract will not take place until these requirements are met although the contract is legally concluded already. As noted in the previous chapter of this book, a certain number of contracts in China would not have effect until approved or registered. In addition, even if a contract is not required for approval or registration, it may not take effect after conclusion in case where the contract is found to have not met the requirements for effectiveness.

The common standards under which the effectiveness of a contract is tested are the standards set forth in Article 55 of the Civil Code. In accordance with Article 55, a civil legal act shall meet the following standards: (a) the party has relevant capacity for civil conduct, (b) the manifestation of intention is genuine, and (c) there is no violation of law or public interest.[51] Since a contract in China is regarded as a civil legal act, to be effective it must therefore be in compliance with these standards.

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[50] See Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3 at pp. 500–509.

[51] See the 1986 Civil Code, art. 55.

Thus, in the sense in which the contract conclusion differs from the contract effectiveness, a contract in China in light of effectiveness may be characterized as valid, void, viodable or effect-to-be-determined contract.[52] The validity issues of the contract will be discussed in the next chapter of the book. Moreover, the effectiveness of a contract would also be affected if there is an agreed condition for the effectiveness of the contract and the condition is not met.

4. Formality of Contract

For the matter of contract formality, the Contract Law takes a more flexible approach than the previous contract legislations.[53] It is believed that since the contract is an agreement between the parties, it is then up to the parties to choose whatever format they see fit for the contract, as long as there is no violation of the statutory requirements. But it is important to note that there are no such provisions in Chinese contract law as statute of frauds in the U.S. pertaining to the writing requirement. In addition, although the contract formality requirement under the Contract Law is less restrictive than it used to be, the writing is generally preferred and in some cases is still required. This practice seems to be in consistence with China's reservation to Article 11 of the United Nations Convention on Contracts for the International Sale of Goods (CISG). Under Article 11 of the CISG, writing is not required for the contracts for sale of goods.[54]

Pursuant to Article 10 of the Contract Law, a contract may be made in writing, orally or in other forms. Article 10 further provides that a contract shall be made in written form if the laws or administrative regulations mandate that the contract be made in writing.[55] The cases in which Article 10 applies refer

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[52] Effect-to-be-determined contract is the contract that has been concluded but is vulnerable to its effectiveness mainly because the party or parties to the contract are lack of capacity. The situations in which a contract would be deemed valid, void, voidable or effect-to-be-determined will be discussed in details in Chapter VII.

[53] The previous contract legislations in China all had a particular emphasis on writing for the contract, and made the writing a general requirement for every contract except for those made and executed instantly. For example, under Article 3 of Economic Contract Law, an economic contract, if not made and executed instantly, shall be in writing. The rigid writing requirement is said to be consistent with the idea that contract was a tool to implement the state economic plan.

[54] Article 11 of the CISG provides that a contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses.

[55] See the Contract Law, art. 10.

to those that the law and administrative regulations contain specific writing requirement for the contract. A good example is the contract for transfer of real estate. Another example is the contract for the transfer of technology. In these contracts, writing is required. Additionally, if the parties agree to the condition that a contract should be made in writing, the contract as such shall then take a written form.

A necessary question concerning the formality of the contract is the effect of formality. To be more precise, the question involves whether a violation of the formality would render the contract void. Scholars in China take different approaches on this matter and their opinions are divided into three categories. The first category is the "effect approach." This approach regards the formality as a mandatory requirement for a contract to be valid unless the law contains optional language such as "may" or "can" with regard to the formality. Therefore, under "effect approach," a failure to follow such requirement would necessarily make the contract void.[56]

The second category is known as "conclusion doctrine." Following this doctrine, the formality would affect the conclusion of a contract. Put differently, the formality would be the prerequisite for a contract. The rationale underlying this doctrine is that for a contract to be made, in addition to an agreement of the parties, the agreement shall be manifested in certain form as required by law. If writing is required, the contract must be recorded on the paper or otherwise there would exist no contract because the law would not recognize the contract not conforming to the writing requirement.[57]

The third category is called "evidentiary theory." Under this theory, the formality of a contract has nothing or little to do with either the conclusion or the effect of the contract, but rather it serves mainly as an evidence to prove the existence of a contract. Thus the writing requirement shall affect the contract only to the extent of existence of the contract or certain contents of the contract. The major difference between "evidentiary theory" and "conclusion doctrine" is that in accordance with the former the violation of writing requirement would not necessarily defeat the conclusion of a contract, but under the latter it would.[58]

The Contract Law seems to have adopted the "evidentiary theory" with respect to writing requirement. First, the Contract Law departs from the practices in the previous contract legislations and does not make the contract formality mandatory. Second, the Contract Law allows the parties to make decision as to whether a contract for which writing is not required by law shall be made

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[56] See generally Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3 at pp. 464–469

[57] See *id.*

[58] See *id*.

in writing. Third, even if writing is required for a contract either by law or by the parties, the conclusion of the contract may not be affected. For instance, in Article 36 of the Contract Law it is explicitly provided that a contract, which shall be made in writing as provided by the laws or administrative regulations or as agreed upon by the parties, shall be concluded if writing is not used but one party has performed its principal obligation and the other has accepted the performance.[59] Article 37 of the Contract Law has the same provision but deals with a written contract without signature or seal.[60] Fourth, the Contract Law does not make the writing an element for the determination of the effectiveness of a contract, whether or not the writing is required. The following case may serve as a good example in this regard.

Zheng Dejun v. Beijing Dongxu Property Management Co. Ltd. and Beijing Zongji Real Estate Development Co. Inc.

Beijing Tongzhou District People's Court[61]

Defendant Dongxu Property Management (Gong Xu) was entrusted by Defendant Zhongji Real Estate Development (Zhongji) to manage the real property named Huaxing Residence Quarter developed by the Zhongji. Dongxu's management was under supervision of New Hua Lian co. (New Hualian), a subsidiary of Zhongji.

Zhongji had three old boilers located in Huaxing Residence Quarter. In 2001, Zhongji wanted to sell the three boilers and asked New Hualian to find a buyer. Mr. Li Zijing, the Vice President of New Hualian, who was in charge of supervision over the work of Dongxu, designated Dongxu to identify a buyer.

Attempted to sell the boilers, Mr. Zhang Chenghua, a manager of Dongxu, contacted Mr. Li Zhenzhou who used to work with Dongxu and asked Li Zhenzhou to help find a buyer. Li Zhenzhou then contacted Zong Shaozeng and Gao Lianyong, and Zong and Gao then found the Plaintiff as a potential buyer. Requested by Plaintiff, Zong and Gao, through Li Zhenzhou, went to Dongxu to meet with Zhang Chenghua. After initial negotiations, they agreed on the price of the boilers: RMB 80,000 each. Zhang Chenghua then drafted an agreement for transfer of the boilers. Thereafter, Zhang Chenghua told Zong and Gao to wait for his further notice because he would have to report the sale to Li Zijing for approval.

On June 24, Zong, Gao and Li Zhenzhou went to New Hualian again to talk to Li Zijing. Upon Li Zijing's suggestion, a clause concerning buyer's responsibility for disassembling

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[59] See the Contract Law, art. 36.

[60] As noted, under Article 32 of the Contract Law, where a contract is made in written form, the contract is concluded when both parties sign or affix a seal on it. Article 37 provides that a contract, which is made in writing, shall be concluded if one party has performed its principal obligation and the other party has received it before the contract is signed or the seal is affixed.

[61] This case was reported in the First Civil Division of Beijing High People's Court, *"A Precise Analysis of Beijing Civil Cases"*, Law Press 2003 at pp. 192–196.

the boilers was added into the Boilers Transfer Agreement and the purchase price remained unchanged. The Agreement was then produced into two printed copies, but the signing party for Plaintiff was Zong Shaozeng instead of Plaintiff. After the agreement was affixed with Dongxu's official seal, Zong and Gao took it to Plaintiff. Upon receiving the agreement, Plaintiff crossed out the name of Zong Shaozeng and wrote down his own name instead.

By the end of June, Li Zhenzhou informed Zong that Li Zhijing thought the purchase price was too low and wanted to renegotiate with Zong and Gao. Zong responded by saying that the parties had signed the agreement and should go ahead with the agreement. During the meeting with Li Jingzhou, however, Li Jingzhou asserted that the agreement was invalid because the boilers belonged to Zhongji not Dongxu, and also the buyer's name was changed. Zong and Gao explained that Plaintiff was the actual buyer. After further negotiations, the parties orally agreed that Plaintiff would purchase the three boilers at the price in a total amount of RMB 260,000.

On July 1, Zong and Gao were invited to Li Zhijing's office to sign the revised agreement. Li Zhijing showed them the written agreement in which Zhongji was the seller and Plaintiff the buyer, and purchase price was RMB 260,000. However Li Zhijing told Zong and Gao that the agreement would need the signature of the company officers, but the contents of the agreement would not be changed. Li Zhijing then asked Zong and Gao to make payment and said that the signed agreement would be made available to the buyer when the payment was made. On July 3, Plaintiff had RMB 260,000 delivered to Li Zhenzhou, for which an acknowledgement bearing Zhongji's official seal was issued to Plaintiff, and RMB 260,000 was deposited at New Hualian's bank account. On the same day, Plaintiff dispatched his workers to start disassembling the boilers, and in the meantime, Dongxu had the documents of all three boilers handed over to Plaintiff.

On July 5, Dongxu told Plaintiff that Zhongji disagreed to sell the boilers to him. As a result, Dongxu disallowed Plaintiff to take away the disassembled boilers. Plaintiff then brought a lawsuit against Defendants, asking the court to order Defendants to continue performing and to pay Plaintiff for economic damages of RMB 6,000. In addition, Plaintiff asked Defendant to refund RMB 20,000 on the basis of the original agreement that had a purchase price of RMB 240,000.

Defendant Dongxu argued that the boilers in question were owned by Zhongji, and although Zhongji asked orally Dongxu to find buyer, it did not entrusted Dongxu to sign the agreement on Zhongji's behalf with Plaintiff. Defendant Dongxu further argued that the final agreement for purchase of the boilers was entered between Zhongji and Plaintiff, and therefore, the previous agreement between Dongxu and Plaintiff was void. In addition, Defendant Dongxu asserted that since Plaintiff gave the purchase money to Zhangji, Plaintiff had no cause of action against Dongxu.

Defendant Zhongji argued that it never entrusted Dongxu to sell the boilers, rather it only asked Dongxu to help find the buyer, and there was no contractual relationship between Zhongji and Plaintiff because Zhongji did not sign any agreement with Plaintiff. Defendant also argued that it did not receive the payment made by Plaintiff and the payment was kept at the account of New Hualian who had no knowledge about the purchase. Defendant asserted that the acknowledgement of the receipt of Plaintiff's payment issued by New Hualian was not Zhongji's official receipt.

The district court finds that Li Zijing of New Hualian represented Zhongji to negotiate the purchase agreement with Zong and Cao, and drafted and modified certain terms of the Agreement, and in particular during last negotiation Li Zijing explicitly told Plaintiff to obtain the signed Agreement upon payment of the purchase price. The district court then

holds that although Li Zijing may have exceeded his "agency power" authorized by Zhongji, he clearly had "apparent authority" to deal with Plaintiff. With regard to the agreement, the district court finds that Zhongji did not officially signed a written agreement with Plaintiff, but Zhongji, through New Hualian, indeed received Plaintiff's payment for the boilers. The district court therefore holds that making a payment constitutes the major performance in a sale contract, and because of the payment of which Zhongji acknowledged, a valid agreement between the parties should be deemed to have existed.

According to Article 37 of the Contract Law, Zhongji's argument that there existed no contractual relationship between Zhongji and Plaintiff is therefore denied, and a judgment is entered for Plaintiff.

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In *Zheng Dejun*, the rationale under which the court judgment was based was that as the buyer, Plaintiff performed his obligation by making the payment in full, and as the seller Zhongji accepted the payment despite the fact that there was a lack of written agreement between Plaintiff and Zhongji, and Zhongji's conduct explicitly indicated Zhongji intention to sell the boilers to Plaintiff.

As far as writing is concerned, it is defined in Article 11 of the Contract Law to mean the forms that can show the described contents of the contract visibly, such as a written contractual agreement, letters, and data-telex (including telegram, telex, fax, EDI – electronic data interchange, and e-mails).[62] For a written contract, it is generally required to bear the signatures of the parties or the affixed seals. However, with regard to what would be the other forms of the contract as indicated in Article 10, the Contract Law contains no definition. Some scholars characterized the other forms as special forms such as notary public, verification, approval as well as registration.[63] In the following case, the Beijing No.1 Intermediate People's Court applied Articles 10 and 11 of the Contract Law to determine the formality of an Internet service agreement.

Lai Yun Peng v. Beijing Stone Lifang Information Company, Inc.

Beijing No. 1 Intermediate People's Court[64]

Plaintiff Lai Yun Peng, 27 years old, resides in Heping District, Tian Jin. Defendant is an information service corporation located in Haidian District, Beijing. Plaintiff sued defendant for the continuing performance of service for a 50 MB online free mailbox.

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[62] See the Contract Law, art. 11.

[63] See Jiang Ping, *Detailed Explanations to the Contract Law of China, supra* note 9 at pp. 10–11.

[64] This case was published as a distinctive case by the Supreme People's Court on March 31, 2003, also available at http://www.court.gov.cn/popular/2003003310082.htm

The facts of this case were not very complicated. On April 22, 2001, plaintiff registered as a user of Defendant-owned "Sina.com" through the Internet, and chose to use the "free mail" service provided by "Sina.com". When providing this service, "Sina.com" promised to make the "free mailbox" with 50 MG capacity. On the date when plaintiff made the registration, he received from "Sina.com" a reply message confirming a successful registration and eligibility to use the 50 MG free mailbox. During the use of the mailbox, "Sina.com" never charged any fees for the e-mails. The daily information services provided by "Sina.com" also include a large amount of commercial information, and when browsing information or handling personal emails, an end-user often interacted with auto-popup plus-ins of commercials, but it was up to the end-user to decide whether to read the commercials.

On August 2 and September 13, 2001, "Sina.com" sent a notice to all free mailbox users on the web, indicating that from September 16, 2001, the capacity of the free mailboxes would be adjusted and only 5 MB free mailbox service would be provided free of charge. The adjusted service was effective on September 16, and 50 MB free mailbox service was reduced to 5 MB.

Plaintiff brought this lawsuit against defendant, claiming that defendant promised to provide 50 MB free mailbox service, the change of service by abruptly reducing the capacity of mailbox from 50 MB to 5 MB without the agreement from all users constituted a breach of contract. Plaintiff argued that although the service seemed to be free, it was actually not free because when user sent emails from the mailbox, the commercial advertisement placed by defendant was always attached to the mails. Plaintiff asked the trial court to order defendant to continue providing 50 MB free mailbox service as it promised.

To rebut, defendant asserted that the "Sina.com" provided service to the users according to the service agreement. The full contents of the agreement were made available to each mailbox user when such user registered his or her membership. The user may become the member and start using the free mailbox only after he or she clicked "I agree" in the space given at the end of the agreement. In the agreement, it was clearly provided that the "Sina.com" reserved the right to make necessary adjustment to the articles of the agreement, and whereby defendant may change and suspend the service. Therefore, defendant asked the trial court to dismiss plaintiff's claim by arguing that the adjustment made to the capacity of the free mailbox was not a breach of contract.

The trial court found that there were 15 articles in the "Service Agreement of Sina.com Beijing Gateway", which contains such contents as the holder of the right to provide the service, status of the web operator, services to be provided, change of and amendment to the service agreement, as well as users' conduct rules. In the provision of "confirmation and acceptance", it reads: "The Sina.com has the right to amend the terms for services if necessary, and whenever a change is to be made, a notice shall be made on the important page of Sina.com's web. If a use disagrees to the changed terms, it may opt out by canceling its use of the services. If however the user continues using the mailbox after the change, it shall be regarded to have accepted the changed terms. In addition, the Sina.com reserves the right to amend or suspend the services at any time without bearing any responsibility for any user or a third party".

The trial court held that the "Service Agreement of Sina.com Beijing Gateway" was the promise to provide information service to customers and the Agreement provided the rights and obligations of the Sina.com in offering such services. Therefore, the Agreement is actually an information service contract in the form of data-telex. Under Article 10(a) of the Contract Law, a contract may be concluded in written, oral or other forms. Article 11 further provides that the written forms are the forms that may visibly show the described contents,

such as written agreement, letter and data-telex (including telegram, telex, fax, EDI and e-mails). The trial court concluded that a contract between plaintiff and defendant in the use of the free mailbox was concluded when plaintiff clicked "I agree" at the bottom of the contexts of the agreement provided online.

In reaching its conclusion, the trial court reasoned that under the defendant's registration procedure for the free mailbox membership, the applicant might complete the registration only after he agrees to the terms of the services. When making the registration, plaintiff followed this procedure and made the choice of "I agree". It is then reasonable to infer that plaintiff was aware of the contexts of the agreement. Plaintiff voluntarily clicked "I agree", which was an indication that plaintiff was willing to be bound by the provisions of the Agreement. Since the free mailbox was the service provided to plaintiff by defendant free of charge, defendant, when offering this service, has the right to explain how such service is to be provided and to make certain reservations in order to maintain its business interests. In addition, defendant may make reasonable changes to the services by giving a notice or according to the agreed terms if the changes do not violate mandatory rules of the law.

The trial court further held that under the agreed terms of the Agreement between plaintiff and defendant over the free mailbox, whether the Sina.com may attach commercials into plaintiff's personal web-page does no constitute a right-and-obligation relationship corresponding to the service for the use of free mailbox. When offering the free mailbox to plaintiff, defendant did not deceive plaintiff nor did defendant conceal anything from plaintiff, not did defendant impose on plaintiff any obligation or liability. Therefore, the validity of the Agreement entered between plaintiff and defendant concerning the free mailbox services shall not be affected. Defendant, under the provisions of the Agreement, made changes to the contents of the services without violation any regulations and law and with a proper notice. Such changes did not constitute a breach of contract. On November 15, 2001, the trial court entered judgment in favor of defendant, and dismissed plaintiff's claim.

Plaintiff appealed on the ground that the trial court erred in determination of the facts because the Service Agreement shall be deemed as invalid standard contract. The appellate court agrees that the Service Agreement in question is provided by defendant online, and is a standard contract because it is pre-made by one party and could be used repeatedly. For the information service on the Internet, the service provider and user are communicated through website. The use of standard contract on line for the users to choose, under which certain right-and-obligation relationship is formed between the users and provider, is not a violation of the law. The standard contract so concluded shall be regarded valid as long as the agreed terms are not prohibited by the law. In the instant case, to invalidate the Service Agreement, plaintiff must prove that the Agreement has (a) caused damage to the State, collective or other party's interest, (b) harmed social and public interest, or (c) exempted defendant from the liabilities, aggregated the liabilities of plaintiff, or excluded major rights of plaintiff. Since plaintiff failed to provide any evidence in this regard, the Agreement shall be held legally binding on the parties.

The appellate court holds that since the free mailbox is a free service unilaterally provided by defendant, defendant shall have the right to make reasonable changes according to the provisions of the Agreement. When the free mailbox was adjusted from 50 MB to 5 MB, defendant fulfilled its obligations of explanation and notice set forth in the Agreement by making announcement about the change on its web page. Therefore, defendant's conduct shall be held valid and there is no breach of contract. On this ground, plaintiff's claim must be denied. The judgment from the trial court is affirmed.

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The *Lai Yun Peng* case is interesting because it not only involves the contract form but also concerns the enforceability of "click-wrap" standard-form terms. The appellate court's decision implicates that a contract may be concluded through the Internet and the standard contract will be presumed valid and enforceable unless it is proved that the terms of the contract violate the provisions of law. Clearly the burden of proof is on the shoulder of plaintiff. The standard contract issues will be discussed more in the next chapter of this book.

What is worth mentioning now is the confirmation letter. There is no doubt that the confirmation letter is a type of written form, but under Article 33 of the Contract Law, the confirmation letter generally applies to the cases where a contract is made through letters or EDI, and the parties request to sign the letter of confirmation before the contract is concluded. The language of Article 33 has generated debates among Chinese contract scholars over the legal effect of the confirmation letter. The debates are mainly on whether the letter of confirmation constitutes a special condition attached to the acceptance for such a contract to be concluded or is just part of the acceptance.[65] Other than that, it is agreed that the confirmation letter takes place in the stage of acceptance and may only be requested before the contract is concluded.[66]

A latest development in China concerning the contract form is the adoption of the Law of Electronic Signature. Promulgated on August 28, 2004 and effective on April 1, 2005, the Electronic Signature Law is purposed to regulate the signatory activities on the Internet and establish the legal effect of the electronic signature as applied to contracts as well as other civil documents (excluding the documents involving personal relations – such as marriage, adoption and succession –, transfer of real estate, and public utility services). Under the Electronic Signature Law, the electronic telex that could tangibly represent the contents it contains and could be obtained any time for review and use shall be deemed as the written form that meets the legal requirements.[67] In addition, the electronic telex shall be regarded as original if it could effectively represent the contents it contains and could be obtained any time for review and use, and it could reliably ensure that its contents remain intact and unaltered from the time it is formed.[68]

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[65] See Wang Liming, *Study on the Contract Law (Vol. I), supra* note 3 at pp. 243–246.

[66] See the Economic Law Chamber of the Supreme People's Court, *the Contract Law Explanation and Application, supra* note 22 at pp. 158–159.

[67] See the Law of Electronic Signature of the People's Republic of China, art. 4.

[68] See *Id*., art. 5

5. Incorporation of the State Plan and Government Approval

As we have addressed in the previous chapters, the Contract Law differs sharply from the past contract law legislations in that the Contract Law has abandoned the idea that contract is a tool to implement the state plan. Despite the difference, the Contract Law nevertheless makes no complete departure from the state plan. Although the Contract Law attempts to give the parties the freedom in making a contract by stressing the parties' right to enter into a contract voluntarily without unlawful interference, such freedom, however, may not be exercised in violation of state plan. To say it alternatively, if there is any conflict between parties' right to make a contract and the state plan, the state plan would control.

Because of the priority of the state plan, the Contract Law mandates that the parties affected by the state plan shall enter into contracts in compliance with the plan. As noted, the state plan in the Contract Law is phrased as "mandatory task" and "state purchasing order". The "mandatory task" is referred to the task assigned by the state through administrative means and must be taken and accomplished by the entities affected. The "state purchase order" represents the order placed by one business entity designated by the state to make purchase from another business entity. In the state purchase order case, the contract is to be made between business entities though the state takes a part in it in terms of placing the state purchasing order.

As discussed, under Article 38 of the Contract Law, when the State on the basis of necessity issues its mandatory task or state purchasing order, the relevant legal person or other organization shall conclude contracts between them under the rights and obligations as prescribed by laws and administrative regulations. It is clear that in either state mandatory task case or state purchasing order case, the state plan plays a dominant role in all aspects of the contract and the parties to the contract enjoy very limited freedom. For the purpose of the formation of contract under Article 38, the state plan must be observed and implemented.

In addition to state plan that would affect the formation of a contract, another distinctive character in the Chinese contract law is government approval. To repeat, as required by Article 44 of the Contract Law, if a contract is subject to government approval, such contract, though concluded, will not take effect unless the approval is obtained. What seems problematical, however, is that the Contract Law itself does not specify the contracts that are subject to government approval. Instead, the Contract Law employs so-called "reference clause," which makes Article 44 subordinate to other legislations or regulations. The point is that under the "reference clause," legislature or administrative agency may from time to time determine what contracts must under government surveillance through the approval mechanism.

Chapter V
Terms of Contracts

In most Chinese contract books, the terms of contract are discussed in the context of contents of the contract. From a majority point of view, however, the terms of contract and the contents of contract are not the synonym. For example, according to one argument, the contents of contract should be viewed from two aspects: civil legal relations and intrinsic structure. In civil legal relations aspect, the contents of contract refer to the contractual relationship created between the parties, which represent the rights and obligations that the parties have respectively. With regard to intrinsic structure, the contents of contract are simply the terms of contract because the contents are displayed by the terms.[1] A few contract scholars tend not to make such distinctions and they deem the two to have the same meaning. For example, in one contract law book in China, the contents of contract are defined as the terms of contract or the specific provisions of the rights and obligations of the parties to the contract.[2]

The Contract Law seemingly makes no attempt to distinguish the contents of contract from the terms of contract. Instead, the Contract Law provides that the contents of a contract shall be agreed upon the parties, and shall include

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[1] See Wang Liming, *Studies on Contract Law*, Vol. I, 347–352 (People's University Press, 2002).

[2] See Jiang Ping et al, *A Detailed Explanation of the Contract Law of Law*, 12 (China University of Political Science and Law Press, 1999).

in general certain terms. For purposes of discussion, this Chapter will mainly deal with 4 major issues: the terms generally included in a contract, interpretation of contract, standard terms, and disclaimers.

1. Terms Generally Included in a Contract

What are the terms that a contract shall normally have? Under Article 12 of the Contract Law, the contents of a contract shall be agreed upon by the parties and in general include the following terms: (a) name and domicile of the parties; (b) subject matter of the contract; (c) quantity; (d) quality; (e) price or remuneration; (f) time limit, place and method of contract; (g) liability for breach of contract; and (h) methods for dispute settlement.[3] Obviously, the language of Article 12 has an emphasis on the choice by the parties with regard to the contents of contract.

First, under Article 12 of the Contract Law, the contents of a contract shall be determined and agreed upon by the parties. In the eyes of many Chinese contract law scholars, Article 12 typically implicates the principle of freedom of contract as specified in Article 4 of the Contract Law. Thus, when making a contract, the parties are empowered to decide what they want to be covered in the contract. Second, the terms listed in Article 12 are regarded to be suggestive (or optional) because the tone of Article 12 is not mandatory. This would mean that the parties may or may not use all of them and may also add other terms if necessary for their specific need. Third, the parties may agree afterwards to change the terms and any post agreement so made would be used to replace the responding terms already in the contract.

An important implicit of Article 12 is that there is no requirement that certain terms be included in the contract in order for the contract to be valid. The terms listed in Article 12 are intended to provide the guidance for the parties to decide the contract contents. Consequently then, any missing term in a contract may not necessarily render the contract invalid nor adversely affects the conclusion of the contract.[4] In addition, the terms may vary in different contracts and the parties are free to make their own decision on a case-by-case basis. But the liberal approach taken in Article 12 seems to make somewhat difficult the interpretation of a contract, particularly when certain key terms are not clear or not included in the contract.

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[3] See the Contract Law, art. 12.

[4] In the US, for a sale of goods contract to be valid the quantity term is a must. But this would not be the case in China under the Contract Law.

Perhaps due to the concerns about unintentionally missing-out of necessary terms of a contract, the Contract Law has attempted to make the contract terms listed as more comprehensive as possible. In addition to Article 12 that suggests the terms for a contract in a broad sense, the Specific Provisions of the Contract Law, which govern specific contracts, also contain the provisions that embrace additional terms for particular contract. For instance, in the Chapter 9 – Contracts for Sales, Article 131 explicitly provides that other than those stipulated in Article 12 of this Law, a sales contract may also contain such terms as package manner, inspection standards and method, format of settlement and clearance, language used in contract and its authenticity.[5] A much more detailed provision concerning the terms of a contract can be seen in Article 324 of Chapter 18 – Technology Contracts, which lists 11 terms for a technology contract.[6] Once again, those terms, like the terms provided in Article 12, are not compulsory. But in practice, it is common that the listed terms are all included in a contract.

With regard to the terms of a contract in general, there are a number of issues that deserve further discussions. The first issue deals with name and domicile of the parties. Under the Contract Law, a party to a contract could be either a natural person (human being) or a legal person (corporation). The domicile of a person is defined in Article 15 of the 1986 Civil Code to be the place where the person's residence is registered; if his habitual residence is not the same as his domicile (registered residence), his habitual residence shall be regarded as his domicile.[7] The habitual residence is characterized by the Supreme People's Court as the place where a citizen has consecutively lived for more than one year after leaving his or her domicile.[8] As for a legal person, its domicile is defined in Article 39 of the Civil Code as the place where its main administrative office is located.[9]

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[5] See the Contract Law, art. 131.

[6] Article 324 provides that the contents of a technology contract shall be agreed upon by the parties, and shall in general contain the following terms: (a) the name of project; (b) contents, scope and requirements of the targeted project; (c) plan, schedule, time period, place, areas covered and manners of performance; (d) maintenance of confidentiality of technical information and materials; (e) sharing of liability for risks; (f) ownership of technological achievements and method of sharing proceeds; (g) standards and method of inspection and acceptance; (h) price, remuneration or royalties and method of payment; (i) damages for breach of contract or method for calculating the amount for compensation for losses; (j) methods for dispute settlement; and (k) interpretation of technical terms and expressions.

[7] See the 1986 Civil Code, art. 15.

[8] See Supreme People's Court, "*Opinions (Provisional) on Several Matters concerning Application and Implementation of the General Principles of the Civil Law of China*" (1988).

[9] See the 1986 Civil Code, art. 39.

The second issue concerns concept of the subject matter of contract (*Biao Di* in Chinese). This is the term very commonly used in China to refer to the target of the rights and obligation of the contract. For example, if a contract is to sell a box of wine, the wine is then the subject matter of the contract. In this context, the subject matter of a contract is also called the object of a contract in China. But the confusion often arises between the subject matter of a contract and the purpose of a contract. Literally speaking, the purpose of a contract has a broader meaning than that of the subject matter of a contract because the parties may have the different goal under the contract but the contract may have only one subject matter. To illustrate, a seller may have the goal of getting the payment in full for the product sold, while a buyer might aim at the product that is expected to get, though the subject matter of the contract is the product to be sold (or purchased from buyer's viewpoint).

The third issue involves the term of price. As noted, though China is moving toward a market economy, the state plan still pays an important role in its economy. Therefore, the price that is set for the products or services in China at this point still takes three forms: market pricing, government-mandated-pricing and government guidance pricing. The market pricing is the mechanism under which the price is determined according to the market situation with no involvement of government (State or local) action. The government-mandated-pricing is the way in which the price is pre-determined by the government, and may not be changed without government action. The pre-determined price normally applies to the products essential to the state economy. The government guidance pricing is the method between the above two, with which the price may be determined according to the guidance provided by the government. In the guided pricing, the government normally provides a medium price and also provides a range within which the actual price may be fluctuated as a necessary response to the change of market situation.

Under China's accession to the WTO, China commits to, subject to some exceptions, allowing prices for traded goods and services in every sector to be determined by market force, and China also promises to eliminate multi-tier pricing practices for such goods and services.[10] The exceptions are referred to the products and services that may still be subject to price control with notification to the WTO. As listed in Annex 4 to the accession of China, there are a number of the products and services for which the government-mandated-pricing is

[10] See, Protocol on the Accession of the People's Republic of China, art. 9. WT/L/432, November 23, 2001.

required, and several other products and services are subject to government guidance pricing.[11]

The forth issue is the quality term. In China, the quality not only means the specifications of the subject matter of the contract as agreed upon by the parties, but also means the standards set forth by the State that apply to certain products or services. What is true is that the quality standard provided by the state is only the minimum requirement for quality. Thus, the parties may agree on a higher quality standard than that required by the State, but the quality agreed by the parties may never be lower than the State standard in order for the contract to be valid.

Since the Contract Law leaves to the parties the ultimate right to choose the contract terms and makes no mandatory terms for the contract, it is important that the parties have the terms, particularly the key terms, well defined or addressed in the contract at the first place. This will not only help make the contract better represent the true intention of the parties, but also will help have the contract properly interpreted in case a dispute arises. More importantly, it should be borne in mind that a contract in China will not necessarily become invalid or void simply because of the lack of some key terms.

2. Interpretation of Contract

Interpretation of a contract becomes necessary when the parties dispute over certain word, expression, term or clause of the contract, and the dispute occurs where the parties have different understanding as to the actual meaning of the word, expression, term or clause. In general, the interpretation is to help find out the true meaning of the word, expression, term or clause that is in dispute. And the interpretation may also be extended to certain conduct or event that may affect the contract.

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[11] According to the Annex 4, Products subject to state pricing include tobacco, edible salt, natural gas, and pharmaceuticals as well as public utilities (gas, water and electricity); Products subject to government guidance pricing are grain, vegetable oil, processed oil, fertilizer (Urea), silkworm cocoons, and cotton (not carded or combed); Services subject to government pricing include postal and telecommunication services charges, entrance fee for tour sites, and education services charges; Services subject to government guidance pricing are transportation services charges, professional services charges, charges for commission agents' services, charges for settlement, clearing and transmission services of banks, selling price and renting fee of residential apartments, and health related services. See *id*., Annex 4.

2.1. Contract Interpretation Approaches

In China, there is no unified definition of the contract interpretation. The simplest definition deems the interpretation of a contract as "the analysis and explanation made to the meaning of the contract and related documents".[12] An awkward one describes the contract interpretation as "the work to ascertain the real meaning of the terms of contract and look into the effective intention of the parties through all interpretation rules and means in order to resolve disputes".[13]

A more difficult question concerning the contract interpretation is how the interpretation should be made. The difficulty lies with the existence of different approaches and standards employed in the interpretation. Among Chinese scholars, they are debating on what would be the practical mechanism for contract interpretation. The debates are centered on (a) who could make the interpretation, (b) what should be interpreted, (c) what purpose the interpretation should serve, and (d) under what rule the interpretation should be made.

There are two approaches with regard to who could make the interpretation. One is called "restrictive" approach, which limits contract interpretation to the one made by certain authorities. Under the "restrictive" approach, the contract interpretation may only be made by the court or arbitration body before which the contract dispute is brought. Scholars who advocate the "restrictive "approach take the position that the contract interpretation in the civil law sense only refers to the interpretation conducted by the court or arbitration body.[14] They further argue that the contract interpretation becomes an issue only when the dispute over the contract term arises between the parties, and because the parties differ in their understanding on the disputed term it is necessary to have a "referee" (court or arbitration body) to interpret.[15]

The other approach views the contract interpretation in a much broad sense and is therefore commonly marked as "broad" approach. As opposed to the "restrictive" approach, the "broad" approach argues that the contract interpretation could be made by the parties and others, including judge, arbitrator, agent *ad litem*, witness, notary public as well as appraiser, depending on circumstances under which the interpretation is needed. In addition, according

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[12] See Wang Liming and Cui Jianyuan, *A new Commentary on Contract Law – General Provisions* (reversed edition), 471–474 (China University of Political Science and Law Press, 2000).

[13] See Li Guoguang, *Explanation and Application of the Contract Law*, 518 (Xinghua Press, 1999).

[14] See Liang Huixing, *Rules of Contract Interpretation*, 539 (Law Press, 1997).

[15] See Jiang Ping, *supra* note 2 at p 102.

to the "broad" approach, certain organization such as consumer protection society may also be qualified to interpret certain terms of contract.[16] Despite its broad sense, however, the "broad" approach agrees that other than those made by the court or arbitration body, all contract interpretations would have no legally binding effect though they are important in helping better understand the terms of the contract.

What should be interpreted is the question that goes to the contents or objects of the interpretation. In general, scholars in China seemingly agree that the interpretation is to construe the terms in dispute, and it therefore shall focus on the literal meaning of the term. However, according to many Chinese contract scholars, in order to made the interpretation more meaningful or in other words, closer to the meaning of the terms to be interpreted, several other matters essential to the interpretation should also be included, because in many cases the literal meaning, standing alone, might not be sufficient. One such matter is the purpose of the contract. The reason is that when the parties enter into a contract, they both may have the intended goal for the contract. Therefore, the interpretation shall be made in consistence with the intended goal.

Another matter is the contract itself. Since any term of a contract is part of the contract, thus to interpret a contract term it is important to take the contract as a whole and look into the substantiality of the term to the contract and the relationship between the term and other terms. In this context, therefore, the interpretation shall be made in light of the whole contract. Also a matter important to the interpretation has to do with commercial usages or customs. In real business settings, the commercial usages or customs possess commonly accepted meaning and are widely observed in the given business transactions or dealings. Thus, the usages or customs have great supplementary value to the contract interpretation, specially when the term to be interpreted appeals very vague.[17] In this sense, the commercial usages or customs are often deemed as "blank fillers" that would help define the contractual terms in question.

The purpose that the contract interpretation should serve concerns the ultimate goal or objective of interpretation. Although on its face the interpretation is to reveal the meaning of the term, it is debatable whether the revealing is aimed at ascertaining the actual meaning of the term or digging out the

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[16] See Wang Liming, *Studies on Contract Law*, *supra* note 1 at pp. 412–413.

[17] See generally Jiang Ping, *supra* note 2 at pp. 102–103; Wang Liming, *supra* note 1 at pp. 420–428; Li Guoguang, *supra* note 13 at pp. 518–526; Wang Liming and Chu Jianyuan, *supra* note 12 at pp. 478–485; and Cui Yunning, General View on Contract Law, 34–38 (China University of People's Public Security Press, 2003).

meaning that the parties have intended. It is also arguable whether the interpretation is limited to the meaning of the term or it has to deal with the validity of the contract. Some scholars argue that by inquiring the real meaning of the term according to the intention of the parties, the interpretation is purposed to (a) make the uncertain contents of the contract reasonably certain, (b) provide supplements to the incomplete contents of the contract, and (c) solve the conflicts among the terms.[18]

Other scholars contend that the direct purpose of interpretation is to properly determine the rights and obligations of the parties so that the dispute between them could reasonably be solved. Therefore, they argue, the purpose of contract interpretation is not only to ascertain the contents of the contract but also to make a determination on whether the contract has been concluded and whether the contract so concluded is valid.[19] For example, according to some scholars, the contract interpretation is premised on the conclusion of the contract, and thus the preliminary question concerning the contract interpretation is whether the contact has been concluded, and if not clear, an interpretation shall be made on the issue of the conclusion first.[20]

2.2. Contract Interpretation Rules

In regard to the rule of contract interpretation, there are three theories that are widely discussed in China. The first theory is called "objective expression". Focused on the apparent intention of the parties, the "objective expression" theory is concerned with how the parties' intention could be expressed objectively. Under this theory, the contract interpretation shall be made on an objective standard, that is, when interpreting a contract term or clause, one should look at what the term or clause in question appears to mean. The underlying idea is that the agreement is not merely a mental state of the parties but rather it is an overt act of them. Therefore, in order to the determine the intention of the parties, the inquiry shall not be limited to what the parties may actually have in mind, more weight shall be given to how the parties reasonably act to have their intention expressed.[21]

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[18] See Cui Yunning, *id* at pp. 32–33.

[19] See Wang Liming, *supra* note 1 at pp. 407–409.

[20] A typical example used by Professor Wang to illustrate his point is as follows: A sent B a fax for certain product, and B then immediately delivered the product to A. A refused to accept the product and a dispute arose between A and B. Then to solve the dispute, it must fist look into the contents of the fax to make an interpretation on whether the fax constituted an offer or was simply an invitation for offer. See Wang Liming, *id* at p. 407.

[21] See Cui Yunning, *supra* note 17 at p. 33.

At the other end of the spectrum is the theory of "subjective intention". In contrast with the "objective expression" theory, the "subjective intention" views the actual intention of the parties as being decisive to the interpretation of contract. Under the "subjective intention" theory, to determine the meaning of a contract term or clause, what really matters is not what the intention of the parties would reasonably appear to be, but is what the parties have actually intended. As a result, if the meaning of the term or clause that the parties have intended to give is found to be different from the literal sense of the language used or from the common understanding of a reasonable person, the parties' intention controls.[22]

The third theory is the eclectic theory, which is actually the mix of both "objective expression" and "subjective intention." This theory is eclectic because it does not take the extreme of either "objective expression" or "subjective intention." On the contrary, it tries to narrow down the difference between the two opposite theories and combine them together to make a comprehensive approach. Under the eclectic theory, the contract interpretation shall fist try to ascertain the true intention of the parties because of the paramount significance of the parties' intention to the contract. If however, the parties' true intention could not be determined or there is a lack of common intention of the parties, the interpretation shall be made with recourse to the common understanding of reasonable persons under the same or similar situation.[23]

2.3. Contract Interpretation under the Contract Law

The Contract Law provisions that govern the contract interpretation seem to be the product of the compromise of the above debates. On the one hand, the Contract Law attempts to take the majority position, and on the other hand, it is intended to avoid some controversial issues. Under Article 125 of the Contract Law, with regard to disputes between the parties to a contract arising from the understanding of any term or clause of the contract, the true meaning of such term or clause shall be determined according to the words and expressions of the contract, the contents of relevant clauses of the contract, the purpose of the contract, the transaction usages and the principle of good faith.[24]

For some reason, the Contract Law does not define the contract interpretation. But from Article 125, it can be inferred that the contract interpretation is the process of ascertaining the "true meaning" of the contractual term or

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[22] See Wang Liming and Cui Jianyuan, *supra* note 12 at pp. 474–478.

[23] See Wang Liming, *supra* note 1 at pp. 419–420

[24] See the Contract Law, art. 125.

clause in question. And in order to determine the "true meaning", the interpretation shall be made in accordance with the words and expressions used, relevant clauses, contract purpose, usages as well as in good faith. As far as the interpretation rule is concerned, the Contract Law does not follow either "objective expression" or "subjective intention". But many Chinese scholars believe that the Contract Law in fact is in favor of the rule that combines both the objective expression and the subjective intention.[25]

In addition, the Contract Law contains no reference as to who may make contract interpretation. A prevailing understanding is that the Contract Law does not exclude the parties from interpreting the contract.[26] To put differently, the Contract Law does not rest the contract interpretation with the hands of court or arbitration body only. Consequently, a wide variety of relevant parties (including the parties to a contract) may interpret the contract. But the difference exists in terms of the legal effect of such interpretation, and for the interpretation to be legally binding it has to be made by the court or the arbitration body.

Under the Article 125, the contract interpretation shall begin with the words and expressions used in the contract. Thus the "plain meaning" of the words and expressions seems to be the threshold of the interpretation because no further efforts would be needed if the meaning of the words and expressions could be determined on its face. When the meaning of the words or expression may not be easily ascertained, the meaning should first be determined by looking at other relevant clauses in the contract. If the ambiguity still exists, the interpretation should be made with resort to the purpose of the contract, the transaction usages and the good faith.

What should be noted is that Article 125 makes the principle of good faith an interpretation determinant. Although it seems too abstract to understand how the good faith principle would help ascertain the meaning of a contract term or clause, most contract scholars in China argue that the good faith principle, though left undefined in the Contract Law, plays a significant role in the contract interpretation and must be observed. It is generally understood in China that the good faith is the supreme rule of contract and as applied to the contract interpretation it requires the interpretation to be made according to commonly accepted business ethics in order to ensure the fair dealing. In this

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[25] For example, according to Li Guoguang, the contract interpretation under the Contract Law shall start with the literal meaning of the words and expressions, and then determine the true meaning by examining the parties' intention as expressed with a reference to the parties' actual thinking. See Li Guoguang, *supra* note 13 at p. 521.

[26] See Wang Liming, *supra* note 1 at pp. 412–413.

connection, the application of good faith in contract interpretation is actually the application of the notion of fairness as well as the business and public ethics.

For example, on March 14, 2004, in order to observe the "International Consumers Right Day",[27] Beijing Association of Consumers Protection, on the basis of complaints it received from customers in the year 2003, published a list of 10 major unfaith and unethical business conducts that are regarded as clear violation of good faith principle. This list from one aspect represents how the good faith is understood in the general public of China. The 10 major unfaith and unethical business conducts include (1) use of advertisement or other means to provide false information about products or services to mislead consumers; (2) illegal production and sale of unqualified products; (3) use of the advantage of monopoly or exclusive business position to force consumers to buy its products or services; (4) use of unfair standard contract or terms to increase consumers' obligations and reduce business operator's liability; (5) use of deceived means by malicious collaboration among business operators to allure consumers to buy; (6) intentional omission of product and service information that should be expressly stated; (7) use of inferior materials or cutting down of the work for products or services; (8) intentional breach of the agreement with, or promise to, consumers; (9) intentional concealment of the specification, certificate or other related information of the products or services in order to evade legal obligations; and (10) revelation of consumers' personal information without authorization for purposes of making profits.[28]

However, when the contract interpretation is made in consistence with business and public ethics under the principle of good faith, the contents ascertained as such may not necessarily be the same as the parties have actually intended. It is then argued that in order to make the contract interpretation more meaningful the good faith shall be the last resort to be used for the interpretation. That is to say that if the true intention of the parties could be ascertained by other means of interpretation, the other means shall first be employed. In this regard, the good faith principle is actually to function as the "filler" to fill in the holes that may appear in the contract interpretation. To speak generally, the good faith may be used as a "catch-all" means to deal with the interpretation of contract.[29]

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[27] In 1983, the Organization of International Consumers Union made the March 15 an International Consumers Right Day.

[28] See *Jin Hua Shi Bao* (Beijing Times), March 15, 2004 at p. A12.

[29] In the United States, a distinction is made between contact interpretation and contract construction. The interpretation is to ascertain the meaning of the parties while construction relates the legal effect of words used. According to Professor John Calamari, the construction placed upon an agreement will not necessarily coincide the meaning of the parties. See Calamari & Perillo, The Law of Contracts (5th ed, 1998) 614–615.

It should be emphasized that under the Contract Law the purpose of contract is not only an important factor for contract interpretation, but also a primary basis for the interpretation concerning the different language versions of a contract. The second paragraph of Article 125 provides that where two or more languages are used in the text of a contract and it is agreed that both versions are equally authentic, it shall be presumed that the terms and expressions in different versions have the same meaning. It is further provided that in case where the terms and expressions in different versions are inconsistent, they shall be interpreted on the basis of the purpose of the contract.

2.4. Supplementary Agreement for Uncertain or Missing Terms

Distinctively, in addition to Article 125 that deals with contract interpretation, Articles 61 and 62 of the Contract Law also contain provisions that apply for the determination of the terms of a contract. Under the Contract Law, however, Articles 61 and 62 may apply only when some specific terms of the contract are missing or uncertain after the contract has taken effect. Because Articles 61 and 62 are intended to provide the mechanism under which the contents of contract may be supplemented by making up the missing term or clarifying the uncertain terms, many in China label Articles 61 and 62 as "contract supplement provisions." On the opposing side, however, is the view that Articles 61 and 62 are the same as Article 125 in their function. They believe that Articles 61 and 62 are specific provisions for contract interpretation while Article 125 is a general one.[30]

Under Article 61, if after the contract become effective, there is no agreement between the parties on the terms regarding quality, price or remuneration or place of performance, etc. or such agreement is unclear, the parties may negotiate a supplementary agreement for the clarification purpose. If the parties fail to reach such a supplementary agreement, the terms shall be determined from the context of relevant clauses of the contract or by transaction customs.[31] To be simplified, Article 61 makes it optional for the parties to reach a post-contract agreement to fix the problem of uncertain or missing terms in the contract. Alternatively, as the second resort, the transaction customs may be used to help determine the uncertain or missing terms. Again, note that Article 61 is a special provision applicable only to certain specified terms.

Having considered the difficulties that Article 61 may encounter and the need for achieving the uniform result, Article 62 encompasses more detailed

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[30] See Wang Liming, *supra* note 1 at pp. 428–431; See also Cui Yunning, *supra* note 17 at pp. 159–163.

[31] See the Contract Law, art. 61.

provisions that are aimed at making the determination straightforward. According to Article 62, if the relevant terms of the contract agreed by the parties are not clear, nor can they be determined under the provision of Article 61, the following rules shall be applied:

1. If the quality requirements are unclear, the State standards or industrial standards shall be applied; if there are no such standards, the generally accepted standards or specific standards in conformity with the purpose of the contract shall be used.[32]
2. If the price or remuneration is unclear, the market price of the place of performance at the time when the contract is concluded shall be applied; if the government mandated price or government guidance price shall be followed in accordance with the law, the provisions of the law shall be applied.
3. If the place of performance is unclear, and the payment is in currency, the performance shall be effected at the place of location of the party receiving the payment; if real estate is to be delivered, the performance shall be effected at the place where the real estate is situated; for other subject matters of the contract, the performance shall be effected at the place of the party fulfilling the obligations.
4. If the time limit for the performance is unclear, the obligor may at any time fulfill the obligations, and the obligee may also demand at any time the performance, but the obligor shall be given a necessary preparation time period for the performance.
5. If the method of performance is unclear, the method advantageous to realize the purpose of the contract shall be adopted.
6. If the burden of expenses for performance is unclear, the expenses shall be born by obligor.[33]

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[32] Different from many other countries or international treaties where the quality standards are basically the conformity with sample or the purposes of the contract, Article 62 of the Contract Law requires that the State or industrial standards be met first. There is a similar provision in the 1986 Civil Code. Article 88 (1) of the Civil Code provides that if the quality requirements are unclear, the State quality standards shall be applied; if there are no State quality standards, generally held standards shall apply. In its Opinions on Several Question Concerning the Implementation of the 1986 Civil Code (Provincial), the Supreme People's Court interpreted Article 88 (1) to mean that when the contract contains ambiguous requirements for the quality of product, the parties fail to reach an agreement and there are not State quality standards, the standards set up by State ministries or commonly accepted professional standards shall be applied; in the absence of such ministerial or professional standards, the approved enterprise standards shall apply; if there are no approved enterprise standards, the trade standard of the same industry or the approved standards for the similar products shall apply.

[33] See the Contract Law, art. 62.

In fact, Article 62 in most parts is simply a restatement of the provision of Article 88 of the Civil Code that contains the provisions for determination of uncertain terms concerning the quality, time limit of performance, place of performance and the price of the contract. What is not covered in Article 62 of the Contract Law is the determination of the right to patent application and the right to the use of patent. Under Article 88 of the Civil Code, if in the contract there is no agreement upon the right to application for patent, the party who has completed invention-creation shall have the right to it; if the contract contains no agreement on the right to the use of patent, either party shall have the right of use.[34]

But, in the context of the Contract Law, Articles 61 and 62 seems to be more involved in the performance of contract because they are regarded as being applied only in the stage of contract performance.[35] But whatever understanding there may be, it looks very likely that Articles 61 and 62, as applied to the contract interpretation, may overlap Article 125. A question that would be raised then is what provision should be applied first when it is requested to determine the terms that are uncertain or disputable. Jurisprudentially speaking, since Articles 61 and 62 are designed to cope with specific terms of a contract, their application shall be attempted at the first place. Keep in mind, however, that the application of Articles 61 and 62 is limited to the filling-in of the specific contract terms that are missing. The following case from the High People's Court of Beijing may help better explain the interpretation mechanism employed in the Contract Law and used in the courtroom.

Beijing Big Dragon Mechanical Engineering Co. Ltd.
v.
Beijing Kaibor Paddling Company Inc.

High People's Court of Beijing[36]

On April 2, 2000, plaintiff and defendant signed an "Agreement on the 3rd Phrase of the Project of Excavation of Water Route". Under the Agreement, plaintiff was responsible for excavating, removing, and bulldozing soil, and for leveling riverbed as well as stacking rocks at the riverbank. The total volume of workload was 572,000 cubic meters of soil

[34] See the 1986 Civil Code, art. 88.

[35] Also note that Articles 61 and 62 differ from Article 126 in addressing the issues of determination of the contract terms. Articles 61 and 62 are aimed to deal with determination of uncertain terms while Article 125 is applied for the determination of the terms that are in disputes.

[36] The source of this case is from the First Civil Division of High People's Court of Beijing, *A Precise Analysis of Beijing Civil Cases*, 258 (Legal Press, 2003).

to be measured by plaintiff and verified by defendant. The unit price of the project was RMB 4.80 per cubic meter. In addition, plaintiff was required to pay RMB 100,000 Yuan deposit up front as the fund to guarantee the quality and timely completion of the project. The contract was to be supervised by Beijing Jinze Municipal Mechanical Engineering Company.

After signing the Agreement, plaintiff made payment under the Agreement in the amount of RMB 100,000 to the project guarantee fund, and then started working on the project site on April 6, 2000. However, during the digging-up of the site, it was found that the water level underneath was rising, which caused to increase both the difficulty and costs of the project due to the requirement for more water-drain equipment and the need for drainage while working on the project. On May 20, 22, 23, and 25, plaintiff sent letter four times to defendant reporting the completion of the project and asking for defendant's inspection. Defendant refused plaintiff's request for inspection on the ground that the project had not been complete and the progress of the project was affected by the technical problems confronting plaintiff. Plaintiff then left the project site.

In July 2000, plaintiff brought a lawsuit against defendant at Beijing No. 1 Intermediate People's Court. Plaintiff alleged that it had a valid agreement with defendant on the project and had performed accordingly, but defendant refused to pay plaintiff in the amount of RMB 8,449,657 Yuan for the project completed. Plaintiff asked the court to order defendant to make the payment and also to refund the RMB 100,000 Yuan deposit to plaintiff.

Defendant argued that the project had quality problems and was unfinished. In addition to asking the trial judge to dismiss plaintiff's claim, defendant filed a counterclaim against plaintiff. In its counterclaim, defendant requested the court to (a) render the Agreement void, (b) order plaintiff to pay RMB 1,990,000 Yuan for defendant's economic loss, (c) ask plaintiff to make public apology for the damage to defendant' business reputation caused by plaintiff's petition to the court for attachment, and (d) re-examine and re-appraise the quality of the project. Plaintiff argued that defendant's refusal of plaintiff's request for inspection in May was groundless, and there was no way to re-examine the project at the time of lawsuit because situation of the project site had changed.

During the hearing, the court asked Beijing Gaodi Investment Consulting Company Ltd. to make an appraisal of the value of the said project according to then effective pricing parameter of Beijing City. The result of the appraisal demonstrated that the total value of the project was RMB 9,50,319 Yuan, of which the volume of machine-excavated soil was totaled at 617,277 cubic meters and the unit price was RMB 11.96 Yuan per cubic meter, and total debris removed by mechanical equipment were 12,000 cubic meters and unit price was RMB 7.79 Yuan per cubic meter.

The arguments between plaintiff and defendants were centered on two major issues: the first issue is whether defendant shall make payment to plaintiff for the price of project, and the second issue is how to determine the price of the project if defendant should make the payment. The court held that the agreement between plaintiff and defendant was valid, but during the course of construction, the river-level rose, which made it more difficult and more expensive for plaintiff to complete the project, and therefore it would be obviously unfair if defendant paid plaintiff for the project still at the price on the bases of the agreed cubic meters of the soil (namely 572,000 cubic meters). According to the court, the appraisal by Beijing Gaodi Investment Consulting Company Ltd. on the price of the project was fair.

The court further held that defendant's argument about the incompletion of the project was not supported by any evidence, and should be denied, and defendant's counterclaim should be also dismissed because it was based on the assertion that plaintiff did not complete the project. In its decision to dismiss defendant's counterclaim, the court ordered defendant to pay plaintiff for the project in the amount of RMB 8,499,657 Yuan and to refund plaintiff's deposit of RMB 100,000 Yuan as well. Defendant appealed.

We hold that a great caution must be taken for the application of the standard of obvious unfairness to a contract dispute. A contract that is obvious unfair normally refers to the contract that was concluded to the disadvantage of one party who was clearly lack of experience or was in emergent situation. In this case, the agreement reached between plaintiff and defendant was the real intention of them and did not violate the law, and its validity must therefore be upheld. On this ground the unit price per cubic meter as agreed upon by the parties was effective, by which the parties must be bound. The trial court's decision requiring the project price to be based on the appraisal of a third party violated the agreement of the parties and must then be reversed.

In reaching its decision on the project price, the trial court relied on Article 62 (2) of the Contract Law. Article 62 (2) provides that if the price or remuneration is unclear, the market price of the place of performance at the time when the contract is concluded shall be applied; if the government-mandated- price or government guidance price shall be followed in accordance with the law, the provisions of the law shall be applied". This case, however, does not fall within the coverage of Article 61 (2) because the parties have agreed on the price and the only thing was left out with regard to the price was the unexpected work under the water.

The trial court erred in applying Article 62 to the case where there is specific agreed term concerning certain matter. What the trial court did was to try to use Article 62 to fill the gap, and thus confused the contract interpretation with contract-gap-filling. The difference between contract interpretation and the contract-gap-filling is that the interpretation takes place where a term is provided but it does not clearly express the meaning of the parties, and the contract-gap-filling might be needed when there is no agreed term. Here the price term is clear with regard to all of the work not under the water, and what is needed is to figure out how much it would cost for the work under the water.

It is true that the rising of underneath water level resulted in increase of the work difficulty and costs to plaintiff, for which defendant shall compensate. The compensated amount may be determined on the appraisal of the third party. Thus, the order of the trial court as to the refund and counterclaim is affirmed and the decisions as to the payment of defendant is reversed and modified to the amount of RMB 3,364,021 Yuan.

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The Beijing High People's Court in the *Big Dragon* case attempted to separate the contract interpretation from the gap filling for the contract. In the case where the interpretation is needed, there exist contract terms but meaning of the terms needs to be clarified. The gap filling on the other hand is to help determine the matter that is not covered by the agreed terms or missed out by the parties.

2.5. Proof of the Terms of the Contract – No Parol Evidence

In short, under the Contract Law, the contract interpretation is needed when there appear disputable terms, uncertain or missing terms, or inconsistent versions if the contract is made in different languages. In addition, the Contract Law has special provisions that regulate the interpretation of standard contracts. These provisions will be discussed separately in this chapter. But a common

scheme is that to interpret the terms of contract certain evidences must be sought or presented, particularly when the parties offer contradictive arguments over the specific meaning of the terms or clause.

A hard question in this regard is whether any extrinsic evidence could be introduced to help ascertain the meaning of the term or clause in question. Under Article 61 of the Contract Law, if certain terms of the contract are uncertain, the parties may enter into a supplementary agreement to overcome the uncertainty of the terms in questions. But the supplementary agreement is something that the parties negotiated after the interpretation became an issue. Article 125 of the Contract Law is silent about what the parties may bring up to the contract interpretation, it is then unclear whether other relevant evidence such as the records of negotiation, side agreement, or memos may be used to help interpret the contract.

In China, there is no such concept as "parol evidence" that is popularly used in the United States to bar the admission of any prior writing or oral agreement or contemporaneous oral agreement between the parties to vary or contradict the writing of the contract if the contract is intended to be complete and final.[37] In Chinese courts, an infallible rule is "to seek truth from the fact." In application of this rule to the contract interpretation, it seems very likely that all evidences relevant to help prove the meaning of the parties would be admissible. As a matter of fact, despite the Contract Law provisions, it has been held that in contract interpretation some ancillary evidence or materials could be used to aid the determination of the terms of the contract.

The "ancillary evidence" is understood to include the history of the contract negotiations of the parties.[38] In a book written by a group of judges of the Supreme People's Court to explain the Contract Law, it is suggested that taking the contract as a whole, the interpretation should not be limited to the context of the contract, but rather in order to determine the meaning of the parties, all other materials related to the contract, such as previous drafts, negotiation records, letters, telegraphs, telex, shall all be used.[39] Thus it is discernable that in practice, the Chinese courts are open to all relevant evidences when making the interpretation of the contract. Consequently, an important question the courts may have to face is how to identify the truthfulness of each of the evidences that are introduced.[40]

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[37] See *Johnson v. Curran*, 633 P. 2d 994, 995 (Alaska, 1981). See also UCC § 2-202.

[38] See Cui Yunning, *supra* note 17, at p. 35.

[39] See Li Guoguang, *supra* note 13 at pp. 521–522.

[40] In the Untied States, the parol evidence rule is purposed to secure business stability. As Professor Calamari pointed out, the policy behind the parol evidence rule is "to give the writing a preferred status so as to render it immune to perjured testimony and the risk of "uncertain testimony of slippery memory". But the rule has received many criticisms for its complexity and rigidness.

3. Standard Terms

Standard terms are generally viewed as the special type of written contract, which may become part of a contract or the contract itself.[41] If all terms of the contract are the standard terms, the contract is than called standard contract. In addition, the standard terms may be contained in the contract document itself or in a separate document. Under Article 39 of the Contract Law, the standard terms are defined as the contract provisions which are prepared in advance for general and repeated use by one party, and which are not negotiated with the other party in concluding the contract.[42] It is the first time in modern Chinese contract legislation that the standard terms are provided as the contract form.

The statutory recognition of the standard terms results from the fact that in many business transactions where the services or products provided are stable and the number of the users are quite large, it would greatly increase business efficiency to have the standard terms in the contracts for repeated use and to help simplify the contract making process. The standard terms are normally used in the contracts involving insurance, transportation and the use of public utilities. As a growing trend, the standard terms are more and more sued in the contract concluded through the Internet, particularly in service area. Keep in mind that the legal characteristic of the standard terms is not the function of "repeated-use" but the notion of "prepared-in-advance" by one party.

Because the standards terms are provided by one party in the pre-printed form, the fairness of the terms becomes the issue to which a lot of attentions have been drawn. In the sense in which the standard terms are normally not the product of negotiations of the parties, the contract that contains all standard terms is often called the "adhesion contract", which in most cases is a "take-it or leave-it" deal. Because of the concerns about the fairness, there are certain rules that are generally accepted in China to govern the use of the standard terms. First, the standard terms, regardless of whether they constitute a contract itself or part of a contract, will not take effect unless and until the

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[41] Because of the fact that the standard terms are not made through the negotiations by the parties, rather they are made by one party unilaterally, there are argument about whether the standard terms are the contracts. Some argue that the standard terms are the norms recognized by the law. Others label the standard terms are civil rules or regulations adopted by legal persons. Some contend that the standard terms should be deemed as *de facto* contract because the standard terms exist before the contract is concluded and they are just accepted by the contracting parties as facts.

[42] This definition is consistent with UNIDROIT's Principles of International Commercial Contract (PICC). According to Article 2.19 of PICC, standard terms are provisions which are prepared in advance for general and repeated use by one party and which are actually used without negotiation with the other party.

other party accepts. In addition, if the standard terms are contained in a separate document, for the terms to be effective, they will normally have to be inferred to expressly by the party intending to use them. Furthermore, no standard terms are to be used without the reasonable knowledge of the other party, or put another way, any of the standard terms should not be taken as a surprise to the other party.

The Contract Law seems to have attempted to incorporate these rules into its provisions that are intended to regulate the standard terms. According to Article 39 of the Contract Law, where standard terms are adopted when entering into a contract, the party who supplies the standard terms shall define the rights and obligations between the parties according to the principle of fairness, shall make the other party noted of the exclusion or limitation of the supplying party's liabilities in a reasonable way, and shall explain these terms in response to the other party's request. On its face, Article 39 does not mention the "surprising terms". It, nevertheless, is understood to have implied from the notice requirement that the other party shall not be surprised with any of the standard terms that would adversely affect its interest.[43]

Additionally, Article 40 of the Contract Law specifies several situations in which the standard terms are invalid. First, the standard terms shall be null and void if there exists fraud, duress, illegal purpose, harm to the State, collective, individual or social public interests, or violation of compulsory provisions of laws and administrative regulations. Second, the standard terms shall be invalid if they contain exclusion provisions that are prohibited by laws. Third, the standard terms shall not be employed for the purpose of exempting one party's liability while increasing the other party's liabilities and excluding the other party's major rights. Article 40, however, fails to specify what would be the "major rights." One scholarly interpretation is that the major rights refer to the rights the party normally will have in the kind of contract.

Despite the business efficiency advantage of the standard terms, the impact of the use of standard terms on consumers is obvious. One major concern is the freedom of contract. The question is whether the contract could be made freely and fairly between the parties particularly when the other party is in a

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[43] With regard to the notice, the statutory standard under the Contract Law is "reasonable ways." According to Professor Wang Liming, the reasonable ways should be judged from the following five aspects: (a) the outfit of the notice document – it should be legible enough to attract the other party's attention; (b) the method of giving the notice; (c) degree of explicitness of the language used; (d) time to give the notice – the notice must be given before the contract is concluded or in the process of concluding the contract; and (e) degree of the awareness of the other party – the notice must make the other party fully aware. See Wang Liming, *supra* note 1 at pp. 394–395.

weaker position. Realizing that the standard terms are often abused by the party having the greater bargaining power in the market, many countries have adopted the laws or rules to help maintain the fair use of the standard terms. Apparently, Article 39 of the Contract Law is designed for that purpose, and it represents the legislative efforts to regulate the use of the standard terms in the business transactions. A similar provision could also be seen in Article 24 of the Law of Protection of Consumer Rights and Interests, where business operators are prohibited from imposing any unfair and unreasonable restrictions through standard contract on consumers or reducing or escaping their civil liability for their infringement of the legitimate rights and interests of consumers.[44]

Not surprisingly, Article 39 of the Contract is being criticized for want of actual legal effect because the article only states what obligations the party making the standard terms may have, but provides no punishment for the failure to perform the obligations. A practical question is what standard terms would be considered unfair and unreasonable. Disturbed by the spreading practices of unfair standard terms in the markets, the Chinese Association of Consumer Protection (CACP) – the national consumer protection watchdog – made a survey in 2003 in four major business areas such as government-monopolized public utilities, insurance, real estate and tourism where the standard terms are most heavily used, and found a quite large number of the standard terms that were "despotic" and clearly violated Article 39 of the Contract Law.[45]

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[44] The Consumer Protection Law of China was promulgated on October 30, 1993 and took effect January 1, 1994. Under Article 24 of the Consumer Protection Law, no business operator shall, through such means as standard contract, notice, announcement, entrance hall bulletin, impose unfair and unreasonable restrictions on consumers or reduce or escape their civil liabilities for the harm caused to the legitimate rights and interests of consumers.

[45] These clauses were classified into ten major categories: (a) the clause giving telecommunication company power to set arbitrary expiration date for calling card with the purpose to "take" unused balance; (b) the clause providing that the monthly charge will still apply even if the cell phone service has been cancelled unless certain procedures have been followed; (c) the clause requiring that customers promise not to make claim against the company if the transmitting signal for the use of cell phone is not strong or interrupted; (d) clause requiring customers to prepay the monthly fees for telephone services and to face the risk of suspending the use of telephone line if the telephone charges in any given month unusually exceed the prepaid amount; (e) clause allowing company to alter the contract terms unilaterally without notice; (f) clause granting company the ultimate right to interpret the contract; (g) clause reducing the statutory period of business record keeping; (g) clause requiring customers at their additional cost to only use provided box or materials for shipping; (h) clause limiting customers' option for receiving the shipped goods in order to charge more; (i) clause prohibiting customer from making claims within reasonable period of time. See the report from Xinhua News Agency on July 28, 2003, available at http://people.com.cn/GB/jingji/1047/1988742.html.

According to the CACP, the standard terms are unfair and unreasonable if they are aimed at (a) exempting the party who makes the standard terms from being held liable for any consequences, (b) restricting or excluding the legitimate rights of the other party, (c) providing the party making the standard terms with additional rights in order to reduce its liability, (d) restricting the access of consumers to CACP for assistance; or (e) granting the party making the standard terms the ultimate right of interpretation.[46] However, given the very limited authority of the CACP, it remains questionable whether the abuse of the standard terms could be effectively dealt with under the regime of Article 39.

Like other contract terms, the standard terms also confront with the issue of interpretation, especially when the parties have different understanding about the terms. In contrast to the regular terms of the contract, the standard terms have their distinctions. One distinction commonly discussed among contract law scholars is that the "meaning intended by the parties" may not be a proper parameter for the determination of the terms in dispute because the standard terms in many cases are not the corollary of the negotiation of the parties. Another distinction is that the standard terms normally involve a large number of users (consumers) and therefore affect more social and public interests. For this reason, the rules for interpretation of standard terms are necessarily blended with the policy concerns.

In the Contract Law, the interpretation of standard terms is specially addressed. According to Article 41, if a dispute over the understanding of a standard term occurs, the interpretation shall be made under the general understanding. If there are two or more kinds of interpretations, an interpretation unfavorable to the party supplying the standard term shall be preferred. In case of inconsistence between the standard term and non-standard term, the non-standard term shall prevail.[47] Hence, as articulated in Article 41, to interpret standard terms, three rules shall be followed, which are "general understanding", "unfavorable to supplying party" and "non-standard term preferable". What is important to note is that these three rules may not necessarily take any particular order, when applied to the specific cases.

The application of Article 41 requires some more elaboration. First, Article 41 may not be used to exclude the application of other contract interpretation provisions. This would mean that any of the principles relevant to contract interpretation in the Contract Law might also be applicable to the interpretation of the standard terms in addition to Article 41. Second, from judicial point of view, application of the rules stated in Article 41 is regarded unconditional.

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[46] See *id*.

[47] See the Contract Law, art. 41.

The notion is that as long as the difference between a standard term and a non-standard term exists, the non-standard term must be upheld. Third, the rule of "general understanding" is premised on the idea that the interpretation of standard terms shall be made both reasonably and objectively because the standard terms are provided unilaterally.

An interesting question concerning the standard terms is the effect of individually negotiated terms. This question becomes relevant when the parties have agreed to add certain terms into the standard contract and the added terms are inconsistent with the standard terms normally used to deal with the same or similar situation. The Contract Law provides no clear answer to this question, but the compelling argument is that the individually negotiated terms shall have the effect overriding that of the standard terms. The underlying rationale rests with the dictum *lex specialis derogat lex generalis* (special law derogates general law), although when applied to the standard terms *vis-à-vis* the general terms, the dictum is reversed.

The case below tells how the additional terms agreed by the parties to the standard contract were treated by the people's courts. The interesting part in this case is that the High People's Court of He Nan Province treated the additional terms as a special agreement that supersedes the standard contract. According to the Court, the additional terms would control if there was a discrepancy between the special terms and the standard contract, and if the special terms did not violate any provisions of law.

Kai Feng City Hong Tian Electronics Company, Inc.
v.
Mincheng Securities Co. Ltd.

High People's Court of He Nan Province[48]

Plaintiff, Kai Feng City Hong Tian Electronics Company, Inc., brought this lawsuit on August 25, 2003 against defendant, Mincheng Securities Co. Ltd, concerning a dispute over a trustee agreement on assets management. Defendant demanded that defendant (a) pay plaintiff RMB 50.45 million Yuan for the entrusted fund and accrued interest, (b) pay stipulated damage of RMB 2.41 million Yuan for breach of contract, and (c) pay fine at the rate of .004% per day for the late payment of the fund from August 13, 2003 to the date of actual payment.

In its complaint, plaintiff claimed that on February 17, 2003, plaintiff entered into the "Agreement of Trustee on the Management of Assets" (Agreement) with defendant (the standard contract provided by defendant), and on the same day, plaintiff and defendant signed the "Additional Terms to the Agreement of Trustee on the Management of Assets" (Additional terms), and both the Agreement and the Additional Terms were concluded on

[48] See, The Civil Judgment of High People's Court of He Nan Province, (2003) Yu Fa Min (2) Chu Zhi No. 24.

the basis on the assent of the parties. Plaintiff alleged that on February 13, 2003 plaintiff remitted RMB 48.20 million Yuan as agreed into the special account of the defendant's branch located in Jin Shui road, and entrusted defendant to manage the fund. Plaintiff further alleged that after the agreed six-month period of trusteeship ended on August 18, 2003, defendant did not payback to plaintiff the principle of the entrusted fund and interest amounting to RMB 50.45 million Yuan in total.

Defendant did not submit a written answer to the Court. During the court hearings, defendant admitted facts stated in plaintiff's complaint but argued that the additional terms contained a minimum guarantee clause, which was void because it violated the prohibitive provision of the Securities Law. Defendant also argued that since defendant had prepaid part of the interest to plaintiff in amount of RMB 1.8 million, the actual amount of the fund remitted by plaintiff to defendant designated account was RMB 48.20 million Yuan, and therefore, the principal of the fund shall be the amount defendant actually received.

In response, plaintiff argued that the RMB 1.8 million Yuan was prepaid interest on the basis of RMB 50 million Yuan and therefore the principal of the fund shall remain unchanged. Plaintiff then contended that the Agreement and the Additional Terms are the standard terms provided by defendant, and adopted by the parties by consensus. Plaintiff further asserted that under the Agreement, defendant should provide plaintiff with assets management report and investment manager report, but defendant did not do so nor did defendant make it available to plaintiff any documents evidencing the financial status of the fund under the trusteeship. Plaintiff also proved that according to the Additional Terms, if there is a conflict between the Agreement and the Additional Terms, the Additional Terms control.

Defendant insisted that the Agreement was the standard contract in compliance with the Securities Law, but the Additional Terms were a result of the negotiations by the parties and should be invalid because of the illegal minimum guarantee clause. Defendant argued that it managed plaintiff's fund to make investment in security market on behalf of plaintiff, and under the Securities Law in such operational investment management the parties shall equally share the profit and loss.

The Court found that the actual remittance plaintiff made to defendant for the fund in trustee was RMB 48.20 million Yuan, and defendant did not actually pay Plaintiff RMB 1.80 million as interest.

It is held that under the provisions of "Securities Management Methods" of China Securities Regulatory Commission and business operation scope stated on defendant's business license, defendant is legally qualified as a legal person to engage in asserts management. The Agreement between plaintiff and defendant manifests the true intent of the parties and its contents are not in violation of any prohibitive provisions of law, and therefore shall be held valid. The Additional Terms shall be deemed as a special agreement on the distribution of the profit because it not only provides the rate of return for plaintiff at 4.5% but also makes it clear that any amount exceeding 4.5% shall be paid 100% to defendant as performance bonus. Since the Additional Terms truly reflect the parties' actual intention and because the case involves trusteeship for which there are no prohibitive provisions, defendant's argument against the Additional Terms lacks legal grounds and shall therefore be denied.

Under Article 8 of the Contract Law of the People's Republic of China, a contract that is established according to law shall be legally binding on the parties and the parties shall perform their obligations as agreed, and the contract so established shall be protected by law. Applying Article 8 to the present case, the Court holds that defendant's failure to provide plaintiff with the periodical report on the management and operation of the fund in trust

under the Agreement during the trusteeship and the failure to report to plaintiff on the assert management and to pay plaintiff the principal of the fund and the interest after the trusteeship came to an end constitute a breach of contract.

In addition, pursuant to Article 75 of the Supreme People's Court "Several Rules of Evidence Concerning Civil Litigation", if a party who holds evidence refuses to submit it without reasonable grounds and the other party asserts that the contents of such evidence are something disadvantageous to the holding party, the assertion may be assumed to be true. In this case, since, defendant is able to but does not provide the assert management report, which renders no evidence that the fund in trust experienced any loss or did not reach the level of profit as agreed by the parties, plaintiff's demand shall therefore be granted.

With regard to the fund in trust, the agreed amount by the parties was RMB 50 million of which a receipt of acknowledgement was issued by defendant to plaintiff. However, since the amount of the fund actually remitted to defendant was RMB48.20 million, and the prepaid interest of RMB 1.8 million was nothing more than a promise defendant made to plaintiff and no transfer of such interest money took place, we conclude that the amount of the fund in trust is RMB 48.20 million.

Accordingly, it is ordered as follows:

1. Defendant shall, within 10 days after this judgment takes effect, pay plaintiff the principal of the fund in trust and accrued interest in the amount of RMB 50.369 million Yuan, and shall also pay belated performance fine for the period from August 4, 2003 to the date of this judgment at the rate of .004% of RMB 50.369 million per day.
2. Plaintiff's other claims are denied.

Further, defendant shall bear the litigation fee of RMB 274,310 Yuan and the attachment fee of RMB 275,000 Yuan. If refusing to accept this judgment, either of the parties may, within 10 days after this judgment is served, appeal to the Supreme People's Court by submitting to this Court three copies of the appellate petition and paying appellate fee of RMB 274,310 Yuan.

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4. Disclaimers

In contracts, a disclaimer is the term whereby the parties agree to exempt a party from liability in certain situations, and on this ground, it is also called exemption clause. The disclaimer is often seen in the sales contracts as the device to limit sellers' liability by reducing number of situations in which seller can be found in breach of contract terms. Obviously the disclaimer is a useful tool for a contractual party who wants to be cleared off from certain liability. Once agreed by the parties the disclaimer becomes part of the contract and has binding effect upon the parties unless its effect is invalidated by the operation of law.

The disclaimers are recognized in the Contract Law to the extent that they do not fall within the categories where disclaimers are prohibited. Under

Article 53 of the Contract Law, an exemption clause shall be null and void if it exempts the liability for (1) personal injury caused to the other party and (2) property damages caused to the other party as a result of deliberate intent or gross negligence.[49] As far as the validity of disclaimers is concerned, it has also been argued that in addition to those provided in Article 53, the liability for the breach of contract due to failure to perform may also not be disclaimed by agreement of the parties.[50] In addition, Article 53 applies to the standard terms as well.

Moreover, for a disclaimer to be valid, the other two criteria are also considered decisive. One criterion is that the disclaimer must be made expressly by the parties and may not be inferred or implied because, as noted, a valid disclaimer will bind the parties to the contract. The other criterion concerns the contents of a disclaimer. It is generally held in China that the disclaimer contents as such shall at least contain the matter of disclaimer and the scope of disclaimer. The former refers to the situations to which the disclaimer will apply, and the latter indicates the type and degree of the disclaimer (i.e. partial exemption or complete exemption).

[49] See the Contract Law, art. 53.

[50] The "substantial breach disclaimer" refers to the disclaimer that is aimed at releasing the liability of the party in breach in case where there is a substantial breach of the contract.

Chapter VI
Defenses to Formation of Contracts – Validity Issues

A contract, once concluded by the parties, may not be enforced if there exist some defects affecting its validity. As we have previously discussed, the validity of contracts has received great attention in China and the issues of the validity are separated from those of conclusion of contract. With regard to the Contract Law, the validity of a contract determines whether the contract will be effective and legally binding to the contractual parties. In practice, the validity is perhaps the most obvious target the lawyers would focus on in order to more meaningfully challenge the contract. To begin with, let's take a look at *Shen Yang International*, the case that exemplifies a battle over the validity of a contract after the contract is concluded.

Shen Yang International Technology and Industry Park Company, Ltd.
v.
Shen Yang Electronic Company, Inc.

High People's Court of Liao Ning Province[1]

Appellant (plaintiff at trial court) appeals to this Court from the Civil Judgment "(2002) Shen Min (3) Chu Zhi No. 559" entered by the Intermediate People's Court of ShenYang City for a dispute over a contract of transfer of equity shares.

[1] See, Civil Judgment Document, (2003) Liao Min 2 He Zhong Zhi No. 314.

The facts as pleaded at the trail court are as follows. Appellant and respondent reached a contract for transfer of equity shares on September 24, 2000. Under the contract, appellant would transfer to respondent all 30% of the equity shares of Shen Yang New World Industry Company, Ltd. and the subscribed capital in the amount of RMB 4.2 million that appellant held. It was agreed that the payment of RMB 4.2 million Yuan should be made within 10 days after the transfer of the equity shares was approved by the original approval authority and registered with commerce and industry authority, as well as the legal process of the transfer was complete. The contract would take effect after the said approval and the registration.

After the contract was concluded, on October 30, 2000, the Development Bureau of Shen Yang Economic and Technology Development Zone issued a document of "An Official Reply to the Request for Transfer of Equity Shares of Shen Yang New World Industry Company, Ltd.", approving the transfer of 30% shares and the subscribed capital of RMB 4.2 million Yuan. The Reply required that a registration of change of the shareholder for the transfer be made with relevant registration authority within 30 days after the transfer.

On December 12, 2000, Shen Yang New World Industry Company Ltd. registered the change with local commerce and industry authority. Later on, appellant launched this litigation in the Intermediate People's Court of ShenYang City asking the court to declare the transfer contract invalid on the grounds that the contract for the transfer of equity shares violated Company Law and other provisions of law concerning the transfer of the State owned assets.

The trial court held that the contract for the transfer of shares was valid and should be observed because the intention of the parties as manifested in the contract was true and the contract was made voluntarily with a full compliance with the law. The trial court dismissed appellant's arguments that the contract was void because it violated the law, and it not only infringed the lawful interest of the appellant but also caused a significant amount of State assets to run off. The court reasoned that although the "Methods of Administration of State Owned Assets Appraisal" issued by the State Council on November 16, 1991 required a asset appraisal for the transfer of the asserts possessed by the enterprise on behalf of the State, under Article 45 of the Detailed Rules for Implementation of the Methods of Administration of State Owned Assets Appraisal, promulgated by the State Owned Assets Administration Office of the State Council on July 18, 1992, such appraisal applies to the situation where the Chinese investor has 50% or more shares in an equity joint venture or contractual joint venture.

In this case, according to the trial court, the equity shares to be transferred amounted to only 30% of the total shares of Shen Yang New World Industry Company, Ltd. and did not fall within the scope of required appraisal. And since the appellant had accepted the payment for part of the transferred shares, and the transfer had both been approved by relevant state authority and been registered with local commerce and industry authority, the contract for the transfer had become effective, by which the parties shall be bound. On this ground, the trial court, according to Articles 44 and 52 of the Contract Law, dismissed appellant's complaint by rendering a judgment that (1) the contract for the transfer of the shares entered by the parties is valid and effective, (2) other claims of appellant and respondent are denied. In addition, appellant was ordered to pay the litigation fee in the amount of RMB 31,010 Yuan.

Appellant disagreed and appealed. In its petition for appeal, appellant argued that the share transfer contract was void because it was not a manifestation of the true intention of the parties and without appraisal, and that the contents of the contact violated law because articles 6,7, and 8 of the contract were contrary to the provisions of Company

Law of China that requires creditors' approval for the bearing of the existing debts of the respondent.

In rebuttal, respondent asserted that the transfer was valid because it was agreed by the parties on a voluntary basis and approved by relevant government authority. Respondent further argued that the debts did not exceed the amount of subscribed capital of the shareholders because the worth of transferred shares was RMB 12 million and the debts to be born by shareholders was RMB 6 million Yuan, and due to the uncooperative conduct of appellant, some of the debts failed to obtain creditors' approval, but it shall not affect the effectiveness of the share transfer agreement.

The finding of this Court tells that the share transfer contract was concluded on September 24, 2000 and according to article 6 of the contract, Party B (respondent) accepts the rights and obligations after the transfer. It is found that (a) as of the date of transfer, the total debts of Shen Yang New World Industry Company, Ltd. (New World Industry) were RMB 20 million Yuan, and as a consequence of the transfer, such debts would be born by new shareholders and beginning on the day of transfer respondent was to be responsible for RMB 6 million Yuan debts proportioning to respondent's prescribed capital. In addition, article 7 of the contract states a promise of Party A (appellant) to guarantee the payment for the debts of the New World Industry, which provides that after completion of the registration of the transferred shares, if appellant fails to manage the transfer and then causes damages to the New World Industry, appellant shall be responsible for the payment of debts or damages. Moreover, under article 8 which provides the methods and time limit of the guarantee, the New World Industry shall be a guarantor jointly and severally responsible for ensuring that appellant will keep its promise, and the time of the guarantee of New World Industry has a two-year limit from the date when creditors make claims to the New World Industry after the transfer is complete.

In light of the facts that the share transfer contract on September 24, 2004 was reached on consensus of the parties and approved by the Development Bureau of Shen Yang Economic and Technology Development Zone, and the change of the shares was registered with the commerce and industry authority, we hold that except for its articles 6 (1)(a), 7 and 8, the contract of the share transfer is valid and has no violation of law, and accordingly, the appellant's argument about loss of state owned assets and avoidance of the contract shall be denied for lack of factual and legal grounds.

Under the Company Law of China, after making capital or property contribution to a company, the shareholders only enjoy the ownership of the shares of the company but do not have the right to own the credit rights or control the debt liabilities that belong to the company. However, the shareholders as the contributor of capital have such the owners' rights as being benefited from assets of the company, making major decisions and choosing managerial personnel for the company. On the other hand, the company has the property right of the legal person that is formed entirely by the shareholders' capital contributions, and possess civil rights and bear civil obligations according to law. In a limited liability company, shareholders assume liability towards the company to the extent of their respective capital contribution, and the company is liable for its debts to the extent of its all asserts.

Applying the above rules to this case, we conclude that in the share transfer contract, articles 6 (1), 7 and 8 concerning the agreement on the liabilities to be assumed by the New World Industry violate the provisions of the Company Law for want of the creditors approval, and therefore must be held void, for which both parties are liable, and the appellant's request for the voidance of the contract is granted with regard to these articles. The trial court was right on the finding of facts but erred in part in the application of law, which

must be corrected here. In accordance with Articles 56 of the Contract Law, Articles 3 and 4 of the Company Law, and Article 153 (1)(b) of the Civil Procedure Law, it is so ordered:

1. Reverse and modify the judgment (1) in Shen Min (3) Chu Zhi No. 599 Civil Judgment of Shen Yang Intermediate People's Court: Articles 6 (1)(a), 7 and 8 of the share transfer contract entered between appellant and respondent on September 29, 2000 are null and void, and the remaining provisions of the contract are valid and effective.
2. Affirm the judgment (2) in Shen Min (3) Chu Zhi No. 599 Civil Judgment of Shen Yang Intermediate People's Court.

In addition, the RMB 31,010 Yuan litigation costs at the trial court shall be paid by appellant in the amount of RMB 18,606 Yuan, and by respondent RMB 12,404 Yuan. As to the appellate court costs of RMB 31,010 Yuan, appellant shall pay RMB 18,606 Yuan, and respondent RMB 12,404 Yuan. This judgment is final.

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Clearly, the High People's Court of Liao Ning Province in *Shen Yang International* addressed the contract validity issue separately from the conclusion of the contract. In this case, the contract was duly concluded, but because certain contents of the contract smelled bad in terms of violation of the provisions of law, the contract had to be held partially invalid and therefore unenforceable. In addition, a practical importance of the *Shen Yang International* case was that partial invalid contract terms would not affect the validity of other parts of the contract if the invalid terms could be singled out.

1. Issues at Stake – Specially Addressed in the Contract Law

Given the significance of the validity of contracts, Chapter III of the Contract Law is specially designed to deal with all validity issues in light of effectiveness of contracts. Under the provisions in Chapter III of the Contract Law, a contract may be valid, void, or voidable with regard to its legal effect, or its effect may be subject to a further determination. Generally, a contract will be effective and enforceable if (a) it is made by the parties who possess the required legal capacity, (b) it is the product of real intention of the parties,[2] and (c) it does not violate any law or public interest. In addition, the effectiveness of a contract may also be affected by the conditions agreed upon by the parties.

The issues that may affect the validity of a contract involve several aspects. The most obvious aspect is perhaps the requirement of approval and/or registration. Normally, in accordance with Article 44 of the Contract Law, a legally

[2] As discussed, the question whether the real intention is the true intention or apparent intention of the parties is a matter of standard under which the intention is to be determined.

formed contract without defects takes effect upon its formation (conclusion). However, as described in Chapter IV of this book, if an approval or registration for the contract is required, the contract will not become effective until the said approval or registration is obtained.

With regard to the approval or registration requirement, the Supreme People's Court seems to be lenient as to when the approval or registration shall be obtained. In the words of the Supreme People's Court, the parties may up to the conclusion of the court hearing in the trial obtain the approval or registration if required for the contract.[3] In addition, according to the Supreme People's Court, when the law or administrative regulation requires a registration for a contract, but does not explicitly provides that the contract shall take effect after the registration, the failure of the parties to obtain the registration shall not affect the effectiveness of the contract, but the ownership of the contracted items or other related property right may not be transferred.[4]

The following case explains the situation where the government approval is required for certain contract and how the requirement is enforced specifically.

He Nan Dayou Chemical Products Company Ltd.
v.
Shan Qian Fu Da Coal Mine

High People's Court of He Nan Province[5]

Plaintiff, He Nan Da You Chemical Products Company, Ltd (Da You), is a company with its business address at No. 30 Chengbei Street, Hui Xian City, He Nan Province. Defendant, Shan Qian Fu Da Coalmine (Fu Da), is located at Shan Qian Village, Zhang Zhuang Township, Hui Xian City.

The case was appealed from the civil judgment of Xin Xiang Intermediate People's Court concerning the dispute over the contract of join business operation between Da Yu and Fu Da. The facts of the case, as the trial court found, are as follows:

On December 13, 1996, Da Yu, through Da You Coal Mine formed by Da You, obtained a mining license from local authority. Prior to that, Da You made the investment on exploration of the coal reserves in several areas of Shan Qian Village. From June 1998, Da You started negotiating with Fu Da for a joint operation of the coalmine. During the negotiations, Da You provided Fu Da with the coal reserves materials collected by Da You during the coalmine exploration, and Fu Da copied those materials.

Thereafter, Da You and Fu Da orally agreed as follows: (1) the parties will invest RMB 12.5 million Yuan to form a joint coalmine, of which Da You will invest RMB 2.5 million

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[3] See Supreme People's Court, *Explanations to the Questions Concerning Implementation and Application of the Contract Law of the People's Republic of China*, 1999, art. 9 (hereinafter referred to as "Explanations").

[4] See *id*.

[5] See, Judgment of High People's Court of He Nan Province, (2003) Yufa Min 2 Zhong Zhi No. 47.

Yuan or 20% of the total investment, and Fu Da RMB 10 million or 80% of the total investment; (2) Da You's cost for the exploration will be priced at RMB 4 million Yuan and according to the investment ratio, Fu Da will refund Da You RMB 1.5 million; (3) the RMB 1.5 million Yuan refund will be made to Da You after Da You completes all information related to exploration and receives new mining license; (4) the joint coalmine shall be operated according to the "Charter of Coalmine" adopted by the parties, and after the joint operation starts, the name of the coalmine shall be "Fu Da Coalmine"; and (5) During the first two years after the profit-making year, Da You will not participate in dividend distribution and will also not bear any risk, and after that, the parties will share the profits and bear risk in proportion to their each investment.

Based on the above oral agreement and according to the requirement of the Bureau of Mining Administration, Da You submitted to the authority an application for canceling the registration of Da You Coalmine. From July 17, 1999 to July 27, 1999, Fu Da made three payments to Da You in a total amount of RMB 390,000 Yuan and no more payment was made thereafter. On December 30, 1999, the parties signed "Agreement of Joint Operation of Coalmine" (Joint Operation Agreement) that contained the terms and conditions of the above oral agreement, and the parties affixed to the Agreement with their official seals. On March 8, 2000, Fu Da registered "Fu Da Coalmine" (the entity for the joint operation) with the Provincial Bureau of Commerce and Industry, but the nature of the entity as registered was a collectively owned entity in the name of Sha He Village without consulting with Da You Chemical. On February 25, 2001, per the request of Sha He Village, "Fu Da Coalmine" was renamed as "Shan Qian Fu Da Coalmine", of which Da You was not noticed.

On December 17, 2001, Fu Da obtained the new mining license, which showed that Fu Da's scope of mining was expanded to include the mining areas of former Da You Coalmine, and Da You Coalmine was merged into Fu Da Coalmine. But after paying RMB 390,000 Yuan, Fu Da refused to pay to Da You the balance of RMB 1.11 million Yuan. Da You brought this lawsuit requesting the court to order Fu Da to continue performing the Joint Operation Agreement and to pay the overdue RMB 1.11 million Yuan.

The trial court held that the Joint Operation Agreement entered between the parties did not violate any prohibitive provisions of the law and should be held valid. The approval was not required because there was no evidence that the nature of the contract was to transfer the right of mine exploration. In addition, it could be seen from the document of the Bureau of Mining Administration that the Bureau knew and allowed the merger of the two coalmines, and therefore, the approval of the Bureau could be assumed. Although the Joint Operation Agreement did not mention the merger of the two coalmines, merger should be regarded as the basis on which the Joint Operation Agreement was made. In addition, after signing of the Joint Operation Agreement, Fu Da actually expanded its mining operation to the coalmine that used to be owned by Da You and made three payments to Da You according the Agreement. These facts demonstrated that the parties had performed their contractual obligation, which proved that the contract had taken effect. Therefore, the trial court denied Fu Da's argument that the Joint Operation Agreement did not take effect because it was not approved by the Bureau of Mining Administration, which was required since the Agreement was to transfer of the right of mine exploration.

Fu Da argued that the Joint Operation Agreement was invalid because Da You did not have the right to explore the mine reserves, and the coal reserves materials obtained by Da You during its exploration were also invalid, which made it groundless for the parties to have the joint operation. By dismissing Fu Da's argument, the trial court held that the question whether Da You had the right of exploration should be reported to the relevant

administrative authority for a solution, but should not affect the validity of the Agreement. Under the Contract Law of the People's Republic of China, the validity of a contract shall not be denied as long as the contents of the contract do not violate the prohibitive provisions of the State.

In its judgment for Da You, the trial court ruled that (a) the Joint Operation Agreement entered by the parties was valid and the parties should continue performing; (b) within 10 days after this judgment was effective, Fu Da should pay Da You RMB 1.11 million; and (3) the litigation fee of RMB 15,560 Yuan should be paid by Fu Da.

On appeal, Fu Da argued that the trial court erred in finding the validity of the Agreement and in determination of the nature of the Joint Operation. The Joint Operation Agreement was in fact an agreement to transfer the right of exploration, the right of mining as well as the sale of mineral reserves. In accordance with the "Law of Mineral Resources" of China and relevant administrative regulations, only the geology and mineral resources departments of the State Council and provinces have the right to examine and approve the transfer of the exploration and mining rights, and the materials of exploration may only be used after approval by the mineral resource reserves commission of provincial level or higher. The merger of two coalmines must also be approved by the provincial mining administrative authority.

Fu Da further asserted that since Da You did not have the right of exploration, the exploration materials collected by Da You could not be used, and by using the illegal exploration materials to form a joint operation with Fu Da, Da You purposed to seek exorbitant profits. Therefore, the Joint Operation Agreement was invalid because it concealed illegitimate purpose. Even if the Joint Operation Agreement was valid, because Da You's illegal exploration activity was irreparable and it had lost capacity to perform, Fu Da had every reason to rescind the contract unilaterally. Fu Da also pointed out that the trial court's finding that the negotiations between the parties started June 1998 was erroneous because the parties did not negotiate until summer 1999.

It is found by the Appellate Court that Fu Da and Da You negotiated the joint operation matter in summer 1999 and the Agreement of Join Operation was concluded on December 20, 1999, and the trial court's finding of the negotiation in June 1998 was a clerical error. It is also found that at the time of the Agreement, both Da You Coalmine and Fu Da Coalmine all had legal mining licenses, but no exploration license. According to Da You's explanation, at that time, Hui Xia local geology and mineral resources administrative authority did not give the exploration license to any of coalmines in the area of Hui Xia.

From what has been found, the Appellate Court is of opinion that given the actual situation at the time of contract, the issuance of mining license by Hui Xia local mining administrative authority to Da You should be deemed as an acknowledgement of Da You's exploration activity by mining administrative authority though Da You had no exploration license. On this ground, Da You's exploration materials shall be regarded as being obtained legally. In addition, it is reasonable to conclude that both Da You's investment in the exploration and the result of the exploration constitute Da You's legitimate property right. There is no violation of the law with regard to the agreement between Da You and Fu Da to price the property right at RMB 4 million Yuan, of which RMB 250 was used as investment to form the joint operation of mining with Fu Da.

It is therefore held that the Agreement of Joint Operation is valid and enforceable. The contents of the Agreement tell that the form of the join operation is a joint venture for establishing a new coalmine, a transfer of exploration and mining rights. Although the merger of the two coalmines was not approved by provincial authority, it was approved by Hui Xian local mining administration authority. Also although the provincial approval is

required, the lack of the approval could be fixed by obtaining it afterward, and therefore shall not affect the validity of the Agreement.

Fu Da's argument against the validity of the Joint Operation Agreement is denied and the judgment made by the trial court is affirmed.

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In the *Dayou Chemical* case, both the trial court and appellate court upheld the validity of the Agreement of Joint Operation reached by the parties by loosely interpreting the government approval requirement for the mining license and the merger of the coalmines that involved transfer of exploration and mining rights. Apparently, the courts prefer to maintain the contractual relationship as long as the contract is concluded freely by the parties. An important point is that the courts took a flexible approach to allow the defect in the obtained government approval to be cured without adversely affecting the validity of the contract.

The other aspects concerning the validity of the contract include the capacity to contract, fraud or duress, illegality, mistakes, as well as unfairness. All issues pertaining to the contract validity are dealt with in Articles 45 to 59 of the Contract Law. Since each of such issues has a particular impact on the validity and effectiveness of contracts, it is governed by the difference set of rules in the Contract Law. It should not be ignored that from the viewpoint of many Chinese contract law scholars, the contract validity is the question about how a concluded contract is to be evaluated and effectuated under the law enacted by the State legislature. At a deeper level, the underlying point is that while the conclusion of a contract depends on the intention of the parties, the validity and effectiveness of a contract is subject to the will of the State.[6]

2. Capacity to Contract – Effect-to-be-Determined Contract

At the outset, to enforce a contract requires that the parties to the contract have the intellectual capacity to understand and appreciate the consequences of what they have bargained for. The strong social and public interests necessitate a need to offer legal protection to those who are lack of such capacity or have limited capacity. Traditionally, as a justification under the law, a contract that is defective in the capacity of the parties is either void or voidable.

[6] See Wang Liming & Cui Jian Yuan, *A new Commentary on Contract Law – General Provisions* (reversed edition), 233–240 (China University of Political Science and Law Press, 2000).

In China, however, a majority of contract law scholars prefer to use the term of "effect-to-be-determined" instead of 'void' or 'voidable' to characterize the contract where a party has the limited capacity.

To be distinguished from the void or voidable contract, a contract for which its effect is to be determined is defined by many in China to refer to the situation where after the contract is concluded, it is uncertain whether the contract is effective before certain acts or facts are ascertained.[7] Thus the doctrine of effect-to-be-determined seems to be premised on the presumption that the contract itself is good, but there is a problem in the capacity of a party making the contract. In other words, the effect-to-be-determined does not go to the contents of the contract but the capacity of a party to the contract. Opponents, however, argue that the effect-to-be-determined contract would directly affect the conclusion of the contract because when a party's capacity is limited, the contract would not be concluded without affirmation of a party (e.g. a guardian or agent *ad litem*) who is responsible for the party with limited civil capacity.[8]

The capacity to contract is a matter of civil capacity that is provided in the 1986 Civil Code. Under Articles 11 and 12 of the Civil Code, the civil capacity of a citizen (natural person) is divided into three categories: full capacity, limited capacity and no capacity. A citizen at the age of 18 years or older is an adult, and he or she shall have full capacity for civil conduct and may independently engage in civil activities. A citizen who has reached the age of 16 but not the age of 18 and whose main source of income is his or her own work shall be deemed as having full capacity for civil conduct. A minor aged at 10 or older shall be a person with limited capacity for civil conduct and may engage in civil activities appropriate to his or her age and intellect, but in other civil activities, the minor shall be represented by or obtain the consent of his or her agent *ad litem.* A minor under the age of 10 has no capacity for civil conduct and all civil activities of such a minor shall be represented by his or her agent *ad litem*. According to Article 14 of the Civil Code, the guardian of a person without capacity or with limited capacity for civil conduct shall be the agent *ad litem* for such person.

With regard to a person with mental illness, Article 13 of the Civil Code treats him or her in two different ways. First, if a mentally ill person is unable

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[7] See Wang Liming, *Study on Contract Law*, 540–541 (People's University Press, 2002). But other insist that the effect-to-be-determined contract shall specially refer to the contract where there is limited capacity of the party and its effectiveness requires a relevant third party's affirmation. See Cui Yunling, *General View on Contract Law*, 139–140 (China University of People's Public Security Press) (2003).

[8] See Xiao Xun, et al, *Explanations to the Contract Law of the People's Republic of China*, 185 (China Legal System Press, 1999).

to cognize his or her own conduct, such a person shall have no capacity for civil conduct and shall in civil activities be represented by his or her agent *ad litem*.[9] Second, a mentally ill person who is incompetent to fully cognize his or her own conduct shall be a person with limited capacity for civil conduct and may engage in civil activities appropriate to his or her mental health. In other civil activities, however, a person as such shall be represented by his or her agent *ad litem*. Thus in terms of capacity standard, a mentally ill person with no civil capacity is treated as the same as a minor under the age of 10.

There seems no need to say that because they are unable to reasonably look after their own interests, minors and mentally ill person need to be specially protected by law against knowingly taking advantage of them by others. Consequently, any civil activity engaged by the person who has no capacity for civil conduct or whose capacity for civil conduct is limited without the consent of his or her agent *ad litem* may have no legal effect. For purposes of civil conduct, the agent *ad litem* of a person without or with limited capacity is the guardian of the person. The 1986 Civil Code has a relatively broad definition about the agent *ad litem.* According to Articles 16 and 17 of the Civil Code, the guardian of a minor would include the minor's parents or grandparents, elder bother or sister, or close relative or friend.[10] A person who could serve as the guardian for a mentally ill person without or with limited capacity is spouse, parent, adult child, other next-of-kin relative, or close relative or friend.

In addition to the civil capacity, the effect of a contract that involves agent exceeding authorization or disposition of a piece of property by an improper person needs also to be determined. Therefore, in the application of the Contract Law, the effect-to-be-determined contracts are generally regarded to include (1) a contract that is concluded by a person with limited civil capacity, (2) a contract that is entered by an agent in the name of the principal without authorization; and (3) a contract concerning a property that is made by a person without the right of disposition to the property. In any of these cases, the contract, though concluded, will have no effect unless certain required action

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[9] For example, according to the Supreme People's Court, the civil act of the person of intermittent insanity shall be deemed void if such civil act is proven to take place during the period of morbidity. And the civil act of a person during his state of unconsciousness shall also be deemed void. See Supreme People's Court, *Opinions on Implementation and Application of the General Principles of Civil Law of the People's Republic of China (Provisional) 1988*, art. 67 (hereinafter referred to as Opinions).

[10] Unless they are dead or lack competence, the parents of the minor shall be the guardians. For close relative or friend of the minor to be the guardian, an approval from the work units of the minor's parents or the neighborhood or village community of the minor's residence is required.

has been taken to make the contract effective. Also in the first two cases, ratification becomes critical in regard to the effect of the contract.

2.1. Contract by a Person with Limited Civil Capacity

Under Article 47 of the Contract Law, a contract concluded by a person with limited capacity for civil conduct shall be effective after being ratified afterwards by this person's agent *ad litem*.[11] This provision implicates that a contract made by a person with limited capacity for civil conduct is not necessarily void or voidable by the operation of law, but its effectiveness is subject to the ratification of his or her agent *ad litem*. Although the term of ratification is not defined in the Contract Law, it is commonly understood in China to mean approval, acknowledgement or affirmation. Some argue that the ratification shall also include the forehand approval by the agent *ad litem* even though the Article 47 has used the term "afterwards" to specify the ratification because the approval in advance may still need to be confirmed or proved in order to render the contract effective.

A sharp difference between Chinese contract concept and that of western countries, e.g. the United States, is the understanding of ratification. In American contract law, ratification is regarded as an effective surrender of power of avoidance or disaffirmance, and the power of avoidance may generally be only exercised by the minor or mentally infirmed person unless a guardian is duly appointed.[12] In China, however, ratification is deemed as a civil conduct of agent *ad litem* as authorized by law to protect the legitimate interest of those who have limited civil capacity, and it is rested with the agent *ad litem*. In one contract book, the ratification is explicitly defined as "a manifestation of intent of the agent *ad litem* to acknowledge and accept the effect of the contract a person with limited civil capacity made with other people".[13]

There are two kinds of contracts for which a ratification of the agent *ad litem* is not required when made by a person with limited capacity for civil conduct. Under Article 47 of the Contract Law, a pure profit-making contract or a contract concluded appropriate to the person's age, intelligence or mental health conditions need not be ratified by an agent *ad litem* of such person. The "pure profit-making" means to enjoy all the benefits without bearing any responsibility or liability, which include receipt of reward, donation or payment.

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[11] See the Contract Law, art. 47.

[12] See Calamari & Perillo, *the Law of Contracts* (4th ed), Hornbook Series, 296–305 (West Group, 1998).

[13] See Su Haopeng, *Conclusion and Effectiveness of Contracts*, 251 (China Legal System Press, 1999).

According to the Supreme People's Court, no one may, in the name of the person without or with limited capacity for civil conduct, claim voidness of the conduct of such person to receive reward, donation and remuneration on the ground of no capacity or limited capacity for civil conduct.[14]

The concept of "appropriate to age, intelligence or mental health conditions" refers to the conduct of which a minor or mentally ill person fully understands the nature under the given age, intelligence and mental healthy condition. For a minor, a civil conduct appropriate to his or her age is normally understood to include the activities that do not involve special knowledge, sophisticated understanding or valuables. The activities as such include for example taking bus or purchasing stationary for study. As far as a person with mental infirmity is concerned, a conduct is deemed appropriate if performed under the situation where the mental health of such person permits and he or she understands the nature and consequences of the conduct. A standard that is commonly used in the people's courts is to look at the ability of making a judgment and self-protection of a person in question in order to determine the mental health condition of the person.

The Contract Law does not state the effect of a contract made by a person with no capacity for civil conducts. As we have addressed, Article 12 of the Civil Code regards a minor under the age of 10 as the person without capacity for civil conduct, and requires that the minor be represented by his or her agent *ad litem* in all civil activities of any nature. Since under Article 12 of the Civil Code, a civil conduct of a minor under the age of 10 would have no any legal effect, it could then be reasonably inferred that a contract of which a person without capacity for civil conduct is a party would be void.

2.2. Contract by Agent without Authorization

A contract may be concluded by an agent on behalf of the principal, and if effective the contract so concluded will bind the principal. But for a contract as such to be effective, the agent must have a due authorization from the principal. As a practical matter, the authorization may be made in advance or be acquired afterwards through the ratification of the principal. Without such authorization, the agent will be considered unauthorized agent and thus will have no power of agency. As a general pattern, the "no power" of an agency would be found when (a) there is no authorization, (b) the scope of the authorization is exceeded, or (c) the authorization expires.

In accordance with Article 48 of the Contract Law, if a contract concluded on behalf of principal by a person who is not authorized, who excesses the

[14] See Supreme People's Court, *Opinions*, *supra* note 9, art. 6.

authorization, or whose authorization has been terminated, the contract would have no binding effect upon the principal without the ratification of the principal, and the person who lacks the due authorization shall be held liable.[15] Thus, before the principal's action on ratification, the effect of the contract that is concluded by the unauthorized agent would be pending, and the contract then falls into the category of the effect-to-be-determined.

However, under Article 49, if the other party has reason to believe that the agent has a due authorization, the act of agency shall be effective.[16] Obviously, Article 49 states a situation of apparent authority of the agent, which constitutes an exception to Article 48. As a result, in the context of the Contract Law, the agent authority in making a contract in the name of the principal could be either actual or apparent, and under the apparent authority the agent's activity in the name of principal that would otherwise be invalid may become valid.

Apparent authority is the authority that the agent is deemed to have in the mind of the other party regardless of the actual status of the said authority, except that the other party knows and should know that the agent is not authorized. In Chinese people's courts, there are three circumstances under which an apparent authority might be found. First, although no authorization is made, certain conduct of the principal would create an impression on the other party that there has been an authorization. For example, the principal does not authorize an agent to sign a contract but allows the agent to use the principal's official seal or use a blank contract form bearing the principal's seal. An apparent authority may also stand when the principal knows about the agent's doing something on behalf of the principal without authorization, but takes no action to repudiate it.[17]

Second, an apparent authority might exist if there is a change of authorization that results in narrowing down the scope of the authority granted to the agent but the principal fails to make the change known to the other. Therefore, in the other party's belief, the agent still has the authority as he used to have. In this situation, the principal may still be held liable for the agent's conduct on the principal's behalf with regard to the other party's interests that are involved. The logical reason is that the principal's laches in making the other party aware of the change of the agent's authority shall not overcome the other party's reasonable belief that the agent still has the authority.

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[15] See the Contract Law, art. 48.

[16] See *id*., art. 49.

[17] This is the situation where the principal's consent will be assumed. Article 66 of the 1986 Civil Code provides that if a principal is aware that a civil act is being executed in his name but fails to repudiate it, his consent shall be deemed to have been given.

Third, an apparent authority might also occur where an authorization granted to an agent has been terminated but the principal takes no action to publicly effectuate the termination to make it a known fact that the authorization in question does not exist any more. To illustrate, when an agent's authorization is terminated, the principal shall make a timely public notice in this regard and in the meantime shall make effort to invalidate the document certificating the authorization through the mean of recall or cancellation. Failure to do so may make the principal still liable for the agent's conduct affecting the other party if the other party reasonably believes that the agent remains authorized by the principal, e.g. based on the certificate of agency issued or signed by the principal.

The following case serves as a good example demonstrating how the apparent authority is determined in practical settings.

Guang Zhou Swan Sports Goods Trading Company Inc.
v.
Beijing Photoelectricity Hardware Building Materials Store

Beijing No. 2 Intermediate People's Court[18]

In October 2000, Wu Sufeng, the owner of the two-floor building known as No. 29 of Zhang Jia Cun, Feng Tai District, Beijing, singed a lease agreement with defendant, under which defendant would rent the building at RMB 60,000 Yuan per year for a term of 6 years. After that, Wu Sufeng orally agreed that defendant might sublet the building. In December 2000, Li Qian, in the name of plaintiff, entered into a lease contract with defendant. Under the contract, defendant agreed to rent to plaintiff a 210-square-meter space of the building of No. 29, Zhang Jia Cun. The term of the lease was three yeas from December 25, 2000 to December 25, 2003 at an annual rent of RMB 120,000 Yuan paid in two installments.

According to the contract, during the term of the lease, for whatever reason plaintiff caused damages to defendant, plaintiff should be responsible without condition. In addition, plaintiff should pay defendant all electricity and water bills that actually incurred within the term of the lease. Moreover, any non performance or incomplete performance of the contract should be deemed as a breach of contract and the party in breach should be responsible for actual damages caused to the other plus stipulated damages in the amount of 10% of the annual rent in that given year.

After conclusion of the contract, on December 15, 2000, on behalf of plaintiff, Li Qian paid RMB 5,000 Yuan as deposit to defendant. On December 25, plaintiff wired RMB 55,000 yuan via the commerce bank of Guang Zhou to defendant as the payment for the rent. In that month, defendant delivered the building to Li Qian for him to use. The part of the rented building was used as a store to sell sport wares. On February 4, 2001, at about 10:35 pm, Li Qian called police reporting that the windows of the store were smashed. On March 20, 2001, Li Qian wrote to Li Guo Jun, the legal representative of defendant,

[18] See No. 1 Civil Trial Division, Beijing High People's Court, A Precise Analysis of Beijing Civil Cases, 170 (Law Press, 2003).

requesting to terminate the lease because the door and windows of the building were repeatedly broken by someone and there was no result of settling the matter though several efforts were attempted. In the letter, Li Qian also asked for a refund of the balance of the rent (from March 25, 2001 to June 25, 2001). Thereafter, Li Qian made no further attempt to negotiate with defendant on whether the lease ought to be terminated.

In April 2001, Li Qian moved out of the building. In the end of May 2001, defendant took back the building and at that time both the door and windows of the building remained damaged. Defendant then had all damaged doors and windows fixed at its own cost. In June 2001, plaintiff brought the lawsuit against defendant at Fengtai District People's Court, alleging that plaintiff had orally agreed with defendant to rent defendant's two-floor building, and plaintiff had wired to defendant the half-year rent in the amount of RMB 55,000 Yuan, but as of the lawsuit, defendant never made the building available for plaintiff to use. Plaintiff then sought to recover from defendant the rent payment of RMB 55,000 Yuan.

Defendant argued that defendant signed the lease contract with Li Qian who represented plaintiff, and delivered the building to Li Qian after receiving RMB 5,000 Yuan deposit from Li Qian and RMB 55,000 Yuan rent payment from plaintiff, and therefore, there was no breach of contract on defendant side. Defendant then filed a counterclaim against plaintiff, asserting that plaintiff terminated the contract during the term of the contract without defendant's consent, and then the termination constituted a breach of contract. In addition, defendant argued that during plaintiff's use of the building, the door and windows of the building were all damaged, which cost defendant RMB 9,795.48 Yuan to repair, and therefore, defendant was entitled to the damage of RMB 36,000 Yuan plus RMB 9795.48 of repairing expenses.

To rebut defendant's counterclaim, plaintiff asserted that plaintiff did not actually use the building, and Li Qian was not an employee of plaintiff nor did Li Qian have any agreement with plaintiff concerning the lease of the building. The RMB 55,000 Yuan rent was wired per the request of plaintiff's local representative who had an oral agreement with defendant for leasing the said building for six months at RMB 110,000 Yuan per annum.

In the trial court, it was found that the lease agreement at issue was entered between Li Qian in the name of plaintiff and defendant, and then Li Qian paid deposit to defendant on behalf of plaintiff. Following the hearing, the trial court further found that after conclusion of the contract and payment of the deposit, plaintiff paid defendant part of the rent according to the lease contract, and Li Qian started using the building in the name of plaintiff. Based on the above finding, the trial court held that the conduct of both Li Qian and plaintiff in dealing with defendant was sufficient enough to make defendant to believe that Li Qian was authorized to represent defendant, and therefore, plaintiff should be responsible for the legal consequences of Li Qian's conduct in the name of plaintiff.

The trial court also held that the lease agreement between Li Qian and defendant was legally concluded and valid with binding effect on the parties, and that during the performance of the contract, Li Qian asked for an early termination of the contract, but since Li Qian did not reach a consent with defendant in this regard, the contract should not be deemed as having been rescinded per Li Qian's request for the termination. With regard to defendant, the trial court concluded that pursuant to the lease agreement, defendant was obligated to keep the building in good condition and was responsible for repairing the broken door and windows in a timely manner, and defendant's failure to do so amounted to a breach of contract for which defendant should be held liable.

In its judgment, the trial court, pursuant to Articles 49, 107, 114 and 102 of the Contract Law of China, ordered plaintiff to pay defendant the damage of RMB 3,000 for breach of

the contract, and dismissed plaintiff's claims as well as other claims made by defendant. Plaintiff appealed to No. 2 Beijing Intermediate People's Court alleging that the trial court erred in finding of the facts.

On appeal, the appellate court agrees with the trial court in the finding of Li Qian's authority to represent plaintiff. The appellate court reasons that the facts of the case had a clear indication that Li Qian, though he might not actually be authorized, had an apparent authority to act on behalf of plaintiff. The apparent authority can be evidenced from the conducts of plaintiff: (a) Plaintiff wired to defendant RMB 55,000 Yuan as rent payment and the amount plus the deposit of RMB 5,000 Yuan Li Qian made to defendant matched the half rent of RMB 60,000 Yuan; (b) the building in question was used as plaintiff's local store as well as a distribution center for plaintiff's goods, and when Li Qian called local police reporting the damage of the windows of the building, he explicitly specified that the building was plaintiff's store; and (c) Li Qian wrote to the legal representative of defendant to seek to terminate the contract and the letter was sent in the name of plaintiff. Those conducts constituted a legitimate ground on which defendant would believe that Li Qian was duly authorized by plaintiff.

Therefore, the appeal is denied and the judgment of trial court is affirmed.

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As of now, there is no separate law of agency in China, and the provisions that govern agency and agent-principal relationship are stipulated in the 1986 Civil Code. In the Civil Code, however, the apparent authority is not addressed. The determination of apparent authority is therefore basically an exercise of judicial discretion. The *Swan Sports* case exemplarily illustrated judicial acceptance of the concept of the apparent authority.

With respect to a legal person (a corporation or enterprise), its legal representative or person-in-charge is generally regarded as an agent fully authorized by and for the legal person unless a limited authorization is imposed by the charter of the legal person. A limited authorization would restrict the agent's power to act on behalf of the legal person to the extent of the limitation.[19] Of course, a common assertion is that the authority of the legal representative or person in charge as such for a legal person may only be exercised within the business scope of the legal person.[20]

If, however, the legal representative has exercised the representation beyond his or her authority, an issue that must be dealt with then will be whether such representation has any legal effect. In the past, the people's courts normally regarded such representation invalid unless ratified by the

[19] The legal representative is defined in Article 38 of the 1986 Civil Code as the person who acts on behalf of the legal person in exercising its functions and powers in accordance with the law and articles of the association of the legal person.

[20] Under Article 43 of the 1986 Civil Code, an enterprise as legal person shall bear civil liability for the operational activities of its legal representatives and other personnel.

legal person. The Contract Law alters such judicial practice. Article 50 of the Contract Law provides that where a legal representative or person-in-charge of a legal person or other organization exceeds his or her power to conclude a contract, the act of such representation shall be effective except that the other party knows or ought to know that the representation is beyond the authorized power.[21]

Therefore, in connection with contracts, a legal representative's conduct overstepping the authorized power is now generally deemed valid under the Contract Law. In its "*Explanations to the Questions Concerning Implementation of the Contract Law of the People's Republic of China*", the Supreme People's Court further affirms the validity of a contract that is made by a legal person's agent exceeding authority. Under Article 10 of the Explanations, where a contract is concluded by a legal representative who has overstepped the authorized business power, the people's courts may not avoid the contract on the ground of exceeding authority, except that such contract violates the restriction or licensing imposed by the State on the business transactions or operation, or the law or administrative regulations that prohibit such business transactions or operation.[22]

2.3. Right to Request Ratification or to Rescind Contract

Because the ratification, once needed, will ultimately determine the validity and effect of a contract entered by a person with limited civil capacity or without civil capacity, or by an unauthorized or not duly authorized agent, it is important that the ratification is made in a timely manner in order to reduce the risk of uncertainty that the other party may face. In addition to the concern about the interest of the other party, the social need for stabilizing the business transactions and maintaining a sound order of economic activities would also require an efficient ascertainment of the effectiveness of the contract that is in doubt.

To that end, the Contract Law provides the other party with two alternatives to a contract for which the ratification is wanted. The first alternative is to ask for ratification or to "urge to ratify". Under Articles 47 and 48 of the Contract Law, if there is the need for ratification of a contract, the other party may urge the agent *ad litem* or the principal to ratify the contract within one month.[23]

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[21] See the Contract Law, art. 50.

[22] See the Supreme People's Court, "*Explanations", supra* note 3, art. 10.

[23] As discussed, the agent *ad litem* in China refers to the person who serves as the guardian for the one who has limited civil capacity or has no civil capacity. See the Contract Law, Articles 47 and 48.

If the said agent *ad litem* or the principal makes no expression of the ratification within the one-month period, it shall be deemed as a refusal of the ratification, and consequently the contract shall be regarded void if made by a person without or with limited capacity for civil conduct, or the agent shall be held liable if the contract is made without authorization of the principal.

The second alternative is to rescind the contract. As provided in Articles 47 and 48 of the Contract Law, if the ratification is required for a contract and before the ratification is made, the other party with bona fide has the right to rescind the contract. If the other party chooses to rescind the contract, the rescission shall be made by way of notice. To simplify, the exercise of the right to rescind shall meet two requirements: the rescission must be made before the ratification and a notice of rescission must be given.

As a practical matter for the agent *ad litem* or principal, the one-month time period for ratification serves a two-fold purpose. First, it is the statutory limitation for making the ratification, and second, the right to ratify is waived if not exercised within one month and shall not be revived afterwards. For purposes of ratification, the one-month period starts from the day when the request for ratification is made. The Contract Law however does not provide a time limit for requesting the ratification, and thus it would be up to the other party to decide whether to make a request for ratification. With regard to the term of bona fide, it is understood to mean that the other party did no know or had no reason to know that the party at issue had no or limited capacity for civil conduct or the agent in question had no authority at the time of contract.

2.4. No Right to Dispose

The Contract Law contains a special provision that applies to the situation where a person who disposes of the other person's property through a contract has no right to do so. Under Article 51 of the Contract Law, if a person having no right for the disposal of other person's assets disposes such assets through a contract, only when the holder of the right to the assets ratifies or the person having no disposal right acquires the right after the conclusion of the contract, shall the contract be valid.[24] This provision is unique because it is purposed to establish a rule to deal with the consequence of "no right to dispose" in contract. Because of its involvement in property, Article 51, as many argued, is an introduction of the concept of "right in thing" of property law into contract law.

Perhaps the provision of Article 51 is a bit hard to understand on its face. In essence, it involves the effect of a contract concerning the disposal of a

[24] See the Contract Law, art. 51.

property by the party who is not entitled to. For example, if A borrowed a watch from B, and in the next day A sold the watch to C without B's consent. Clearly, A was not the owner of the watch and had no right to dispose of (to sell) the watch unless so instructed by B. Then, without B's consent, the effectiveness of the contract between A and C for the sale of the watch would of course become a question because A's conduct infringes the ownership of B as to the watch, which would give B every right to reclaim the watch.

The disposal, as specified in Article 51, refers to the legal disposal, which means to determine the fate of the property i.e. to sell the property, to give it away as a gift or to create a mortgage against the property. Under the civil law ownership doctrine, a full ownership consists of three basic property rights: the right to possess, the right to use and the right to dispose. Although each of these three rights may be separated from the ownership, the right to dispose is regarded as the core of the ownership, without which the ownership would not exist. To illustrate, assume that A owns a house, and based on the ownership A has the right to possess, to use and of course to dispose of the house (to sell the house). At his choice, A may rent the house to B and by doing so A's right to possess and use the house would be transferred to B. Despite the fact that A transfers the right to possess and use the house to B, A's ownership to the house is still intact. If, however, A transfers his right to dispose of the house to B, A would lose his ownership to the house.

The implication of Article 51 of the Contract Law is that a contract made by a person who has no right to dispose of the assets in question would be valid only if (a) the contract is ratified by the holder of the right, or (b) the person having no right acquires the right afterwards. In the context of Article 51, the holder of the right includes the person who has the right to dispose of the assets, e.g. an agent fully authorized or a bank in the case of foreclosure, and the proper owner. The acquisition of the right may occur through inheritance, purchase or donation. Thus before the ratification or acquisition, the contract made by the person having no right to dispose is the contract that its effect is yet to be determined.

The idea of no right to dispose and its impact on the effect of a contract may not be seen from the contact law concepts in the US as well as many other common law countries. But in the US the provision that may bear some similarity to the extent that the contract would be affected is the warranty of a clean title for the good to be sold under the UCC. For example, according to § 2-312 of the UCC, in a contract for sales, the seller is responsible for the warranty that the title conveyed shall be good and its transfer rightful. Any defect in the warranty may constitute a breach of contract. Nevertheless, the major distinction is that no right to dispose does not necessarily cause a contract invalid but creates a situation where the effect of the contact need to be further ascertained.

Not surprisingly, Article 51 of the Contract Law turns out to be very controversial because it tends to recognize the effect of the contract made by a party who has no right to dispose of the assets involved at the time of contract. The problem is that Article 51 does not specify what effect of the contract would have if the holder of the right refuses to ratify or no right is acquired by the party in question afterwards. Of course, it might be assumed that without the ratification or acquisition of the right the contract would be void. But a more difficult question that concerns the premise on which Article 51 would stand is whether the contract itself shall be deemed void or the conduct of disposal itself would be invalid, if no ratification or acquisition is obtained. The practical matter is that if the voidness goes to the contract, the contract shall have no effect from the very beginning, but if the conduct of disposal is void, the effect of the contract should not be affected.

Certainly because of the difficulty in resolving the above question that is being debated, the Contract Law makes no attempt to specify the effect of the contract in which a party has no right to dispose absent ratification or subsequent acquisition of the right. The center of the debates is how (and on what legal grounds) to protect the interest of the party who receives the property with good faith or is a bona fide purchaser.[25] Interestingly, notwithstanding the debates and the silence of the Contract Law, the people's courts in their judicial practice have a strong tendency to uphold the validity of the contract made by a person having no right to dispose if the interest of a third party in good faith is involved.

The people's courts' position in favor of a bona fide party has its legal source derived from the Supreme People's Court's opinions on the implementation of the Civil Code and also from the UNIDROIT's Principles of International Commercial Contract (PICC). For example, Article 3.3(2) of the PICC clearly states that the mere fact that at the time of conclusion of the

[25] In drafting the Contract Law, the drafters attempted to solve the "no right to dispose" matter in a more specific way. For example, in January 1995 draft, it was provided that a contract containing the disposal of the property right of other person shall be valid from very beginning if the disposal is ratified by the holder of the right or the right to dispose is acquired afterwards; such contract shall be invalid if the right holder does not ratify or the right to dispose could not be obtained, but the invalidity shall not be used against a bona fide third party. In 1996 draft, the provision was changed to an even more detailed one, which provided that a contract concluded to dispose of the assets of other person by the person having no right to make such a disposal shall be void without the ratification of the right holder or acquisition of the right after conclusion of the contract; a contract to dispose of the property under joint tenancy by one owner without consent of other owners shall be void; but a third party with good faith obtains through registration or payment the property disposed of by the person having no right to dispose or by a owner of the property under joint tenancy without other owners' agreement shall be protected by law. Those attempts, however, all failed due to inability to obtain a majority in favor.

contract a party was not entitled to dispose of assets to which the contract relates does not affect the validity of the contract.[26] According to the Supreme People's Court, during the existence of the ownership of joint tenancy, the act of some co-owners to dispose of the property in join tenancy without consent of other co-owners shall in general be deemed invalid. If, however, a third party acquires the property with compensation and in good faith, the legitimate interest of the said third party shall be protected and the damages caused to other co-owner of the property shall be paid by the co-owners disposing of the property without the other's consent.[27]

Accordingly, in handling the contract cases involving no right to dispose, the people's courts normally use the following two criteria to determine the validity of the contract. The first is to look at whether the third party is a bona fide party, or whether the party knows or ought to know that the person he or she deals with has no right to dispose of the assets concerned in the contract. The second criterion focuses on whether the transfer of the assets in question is made for value. If the third party in good faith acquires the assets through a purchase, the ownership of the property would then be transferred regardless of the original owner's ratification. If however, the third party receives the assets without paying for value, the original owner would have the right to reclaim the assets no matter whether or not the third party is in good faith.[28]

It should be emphasized that the good faith acquisition of assets has gained a great deal of recognition in the people's courts. As a result, in order to protect the third party's interest, a contract concluded by a party having no right to dispose may still be held valid even if the ratification of the right holder or the right to dispose could not be obtained after conclusion of the contract. It seems that the people's courts have incorporated into their judicial practice the doctrine that no right to dispose affects only the validity of the conduct of disposal but not the validity of the contract itself.

3. Void Contracts

A contract shall not be enforced if it is void and its voidness retroactively applies to the date the contract was made. A well-accepted principle is the maxim that a contract that is void now is void from its beginning. Generally speaking, a void contract is the contract that is concluded but violates the law

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[26] See UNIDROIT: Principles of International Commercial Contract, art. 3.3 (2).

[27] See Supreme People's Court, *Opinions*, *supra* note 9, art. 89.

[28] See Li Guoguang, *Explanation and Application of the Contract Law*, 216–218 (Xinghua Press, 1999).

or regulations or does not meet the requirements for the contract to become effective. Therefore, if a contract becomes void, it has no legal effect and of course is not binding. Based on this principle, Article 56 of the Contract Law explicitly provides that a contract that is null and void shall have no legally binding force from the very beginning.

To determine the validity of a contract, the Contract Law has a general list of situations under which a contract is avoided. According to Article 52 of the Contract Law, a contract shall be null and void in any of the following situations:

1. A contract is concluded under fraud or duress employed by one party to damage the interests of the State;
2. Malicious collusion is conducted to damage the interests of the State, a collective or a third party;
3. An illegal purpose is concealed under the guise of legitimate means;
4. Social and public interests are harmed; or
5. Compulsory provisions of the laws and administrative regulations are violated.[29]

It is important to note that the range of void contracts as provided in the Contract Law is narrower than that in the Civil Code.[30] The obvious reason that helps explain the change is that the Civil Code does not distinguish the void contracts from the effect-to-be-determined contracts. For example, under the Civil Code, a contract that is concluded by a person with limited capacity for civil conduct is void while the Contract Law classifies it as the effect-to-be-determined contract, which is not necessarily void. It has been criticized that the Civil Code provides the people's courts with an overly broad discretion to avoid contracts, and consequently the number of void contracts became so large that the very purpose of the Civil Code to maintain the stability of the economic transactions was adversely affected.[31] The Contract Law is intended

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[29] See the Contract Law, art. 52.

[30] Article 57 of the Civil Code provides that the following civil act shall be null and void:
   a. The civil act performed by a person without capacity for civil conduct;
   b. The civil act that may not be independently performed under the law by a person with limited capacity for civil conduct;
   c. The civil act performed by a person against his or her true intention as a result of fraud, duress or exploitation of his or her unfavorable position by the other party;
   d. The civil act performed through malicious collusion to harm the State, a collective or third party;
   e. The civil act that violates laws or social and public interests;
   f. An economic contract that violates the State mandatory plans; or
   g. The civil act performed under the guise of legitimacy to conceal illegitimate purposes.

[31] See Wang Liming, *supra* note 7 at p. 639.

to change this scenario by separating effect-to-be determined contracts from void contracts. Thus, it is discernable that an immediate result of the change will be a significant drop in the number of contracts to be regarded void in the people's courts.

Still, given that the power to avoid contracts may be abused, contract scholars in China strongly advocate for adoption of the rule of statutory-based void contracts. Pursuant to this rule it would be required that no contracts should be regarded void unless provided by law. In other words, except otherwise determined to be void under the law or regulations, all contracts shall be assumed valid.[32] The purpose is to help keep the number of void contracts at minimum. On the other hand, since there is a difference between the Civil Code and the Contract Law in determining the void contracts, a practical question would be which law shall prevail. A qualified interpretation is that the Contract Law controls because it is a special statute as compared to the Civil Code that is a general one.

3.1. Fraud or Duress

A contract will be void if it is concluded as a result of fraud or duress whereby the State interest is harmed. Keep in mind that under the Contract Law, only when the State interest is at issue, does the fraud or duress become the legal ground to avoid the contract. Therefore the trigger of void contract in the case of fraud or duress is the harm to the State interest. This provision is quite different from the Civil Code where a contract would be void if fraud or duress is found regardless of the type of harm to the interest of the State or others.

During the drafting of the Contract Law, many suggested to make fraud or duress the reason that renders a contract voidable but not void. The argument was that it has been the common practice in many other countries where a contract would become voidable if there is fraud or duress committed in the process of making the contract. The suggestion, however, was not accepted by the ruling force in the national legislative body because they believed that the State should have the power to interfere with the contracts whenever the State interest is affected due to the importance of the State ownership in the nation's economy.[33]

Now the hard issue is what would constitute a State interest. One scholarly interpretation is that the State interest mainly includes the State economic, political as well as security interest, excluding the interest of the State owned

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[32] See Cui Yunling, *supra* note 7, at p. 112.

[33] See Sun Lihai, *Selection of Legislative Materials of the Contract Law of the People's Republic of China*, 48–49 (Law Press, 1999).

enterprises.[34] Another scholarly interpretation agrees that the State interest should not mean the interests of the State owned enterprises, but argues that the State interest shall be the interest protected by the public law such as criminal law and administrative law, and that only if a party or parties violate criminal law or administrative law, upon which a criminal or administrative liability will be imposed, shall the State interest be regarded as being harmed.[35]

None of the above interpretations seems persuasive nor does it clearly address the issue. It looks that both interpretations intend to disqualify the government interference with private contracts by excluding the interest of the State owned enterprises. But it would be difficult to see how the fraud or duress to be related to the State political or security interest so that a contract shall be void. And it might also be too abstract to figure out how to attach the State interest to criminal law or administrative law in order to make a contract void on the ground of fraud or duress. Perhaps the legislative intent of the Contract Law pertaining to Article 52(1) speaks itself in this regard: in consideration of the co-existence of State owned, private owned and foreign owned enterprises, this provision not only reserves a legal means for the State to interfere at its own initiative in order to maintain the State interest, but also fits all kinds of situations.[36]

3.1.1. *Fraud*

Unfortunately, neither the Civil Code nor the Contract Law contains a definition about the fraud. But, in the view of the Supreme People's Court, a fraud occurs when a party deliberately provides the other party with false information, or conceals the truth in order to induce the other party to make a mistaken expression of will.[37] Here, the term "fraud", as defined by the Supreme People's Court, seems to include misrepresentation as well, or at least it does not separate out the situation of misrepresentation.[38] It, therefore, could be inferred from the Supreme People's Court's opinion that in a civil action in China no distinction is being made between misrepresentation and fraud.

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[34] See Wang Liming, *supra* note 7 at p. 643.

[35] See Cui Yunling, *supra* note 7 at pp. 112–113.

[36] See Sun Lihai, *supra* note 33 at pp. 48–49.

[37] See Supreme People's Court, *Opinions*, *supra* note 9, art. 68.

[38] In the U.S., a "misrepresentation" is defined as an "assertion not in accord with the facts". See Restatement Second of Contracts § 159. The fraud, though not well defined, is interpreted to include affirmative misstatement (deliberate lie), concealment (hiding the truth) as well as nondisclosure. See Brian Blum, *Contracts, Examples and Explanations* (3rd Ed), 367 (Aspen, 2004).

Consequently, in many contract cases in China, the term "fraud" may actually mean "misrepresentation".

Based on the interpretation of the Supreme People's Court, fraud in contracts is articulated to embrace 4 elements, and each of them, though tersely worded, requires more elaboration. The four elements are (a) intent to deceive, (b) conduct of deceit, (c) reliance, and (d) mistaken manifestation of the will of the deceived.[39] In contrast with American concept of misrepresentation that focuses on concealment and failure to disclose, the fraud as interpreted by the Supreme People's Court of China is more involved in willfully deceptive conduct and the mistakes induced. In addition, in American contract law, the injury might be required to make an actionable misrepresentation case or the injury will be presumed if a misrepresentation is material,[40] but in China injury seems irrelevant to find a fraud (or misrepresentation) in contract.

Intent to deceive

To constitute a fraud, it must be found that there exists the intent to deceive. What is relevant here is the state of mind of the party committing the fraud. The intent to deceive refers to that the deceiving party knows the falsity of the information that would induce the other party to make a wrong decision, and seeks such result to happen or lets the result drift. As noted, fraud is a synonym for misrepresentation in many contract cases in China. And then the requirement of presence of the intent would mean that an innocent misrepresentation would not be actionable in a contract case though it is possible to unintentionally make a misrepresentation.

Thus, to determine the intent to deceive, two factors are essential: knowledge of falsity and purpose to induce. To be more illustrative, an intent to deceive will be found if a person knows or understands that the information he is to give to the other party is false or that the truth of the information is being concealed, and the use of false information or concealment of the truth is aimed at trapping the other party into a transaction or deal that otherwise would not be possible to make. On this ground, scholars in China believe that

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[39] Some argue that fraud consists of three elements: (a) misrepresentation of material facts, (b) reliance and (c) intent. See Economic Law Research Division of the Office of the Standing Committee of the National People's Congress, *Explanation and Application Guidance of the Contract Law of the People's Republic of China*, 65 (China Democracy and Legal System Press, 1999).

[40] See Scott & Kraus, *Contract Law and Theory* (3rd ed), 424 (LexisNexis 2002); See also Calamari & Perillo, *supra* note 10, at p. 329.

when committing a fraud, the deceiving party is maliciously motivated. They also point out that whether the fraud committed is to benefit the deceiving party or a third party will have no impact on the finding of such malicious motive on the deceiving party.[41]

A question whether there is an intent to deceive would arise when a party is not clear about whether the fact is true or false, but states it as a truth in order to induce the other party. For example, a seller wants to sell a piece of painting at a high price, and he affirmatively tells a buyer that the painting is a genuine Tang Dynasty painting in order to induce the buyer to buy, but in fact the seller has no idea about whether the painting is a Tang Dynasty painting or actually a Ming Dynasty one nor does he know whether the painting is a genuine one or a counterfeit. To deal with this issue, some suggest a doctrine of assumption of intent, under which the intent to deceive will be assumed if a party knowingly makes an affirmative statement to the other party about the fact of which its truthfulness is unknown to the party making the statement.[42]

Conduct of Deceit

The conduct of deceit is the action of the deceiving party to carry on the intent to deceive, or the action that turns the intent into an external motion. The mere intent to deceive would not have any practical significance in the finding of fraud unless and until certain action motivated by the intent has been taken, including for example intentional misrepresentation and deliberate concealment of material facts. Intentional misrepresentation is an active action in which the deceiving party knowingly tells to the other party the false or deceptive information, while deliberate concealment is a passive action where the deceiving party purposefully not to disclose to the other party the fact that is material and the deceiving party is under obligation to disclose.

There are two situations where Chinese scholars are debating on whether the conduct of deceit may present. One situation is that a party at the time of contract knew with some certainty that he was lack of capacity to perform but still entered into the contract. In practice, many courts would treat it as a conduct of deceit because the materials fact – capacity to perform the contract – is willfully concealed, which leads to the conclusion of the contract. Such practice, however, is criticized to be rigid and arbitrary because nondisclosure of insufficient performance capacity at the time of contract may not necessarily be fraudulent. If, for instance, a party lacking the performance capacity

[41] See Wang Liming, *supra* note 7, at p. 641.

[42] See *id*.

made a contract with the other in order to cheat for deposit money or upfront payment and never had prepared for the performance, the conduct as such is clearly fraudulent. If, however, a party who was incapable to perform when making the contract believed that he would have the capacity at the time of performance and made every effort to get ready for the performance, the party in such case should not be deemed as having committed the deceit.[43]

The other situation involves silence of a party. The issue is whether it is fraudulent if a party did not tell or disclose essential facts or information. Generally, silence, standing alone, is not a sufficient ground for the finding of fraud. If, however, a party is under obligation to tell or disclose, silence of the party may constitute a fraudulent conduct. According to Chinese contract scholars, the obligation to tell or disclose may arise under the provision of law, trade customs or agreement. For example, if a party is required by the law to provide the other or the public with certain facts or specification of the products or goods, the party's silence about such facts or specification will be regarded as a violation of the law, which would amount to a fraud.[44]

To find the conduct of deceit, there seems no distinction to be made in China between misrepresentation of fact and misstatement of opinion.[45] The issue at heart is whether the party who misrepresents the fact or erroneously states opinion has the intent to deceit or defraud. If the intent is found, it seemingly doesn't matter whether the fact or opinion is involved. As long as the other party is induced to do what the deceiving party expected, either misrepresentation of fact or misstatement of opinion may be regarded as a fraud.

Reliance

Although intent to deceive and conduct of deceit are crucial to find fraud, to recover for fraud it must be proved that the deceived party was trapped to rely on the induction of the deceiving party. Here the reliance means that the deceived party mistakenly believes the deceiving party with regard to the information deceptively given. For example, A wants to sell to B a counterfeit Rolex watch, and in order make the deal, A forged all documents evidencing the genuineness of the watch. If B believes that the watch is a real Rolex as a result of A's misrepresentation, B will be regarded to have relied on the

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[43] See Wang Liming & Cui Jianyuan, *A New Commentary on Contract Law – General Provisions* (reversed edition), 270 (China University of Political Science and Law Press, 2000).

[44] See Su Haopeng, *supra* note 13, at pp. 275–276.

[45] In the United State, although the difference between fact and opinion is regarded as a logical absurdity, it is generally held that misrepresentation of fact rends a contract voidable, while erroneous statement of fact does not. See Calamari & Perillo, *supra* note 12, at p. 330.

information deceptively provided by A, whereby B's misunderstanding is formed.

Obviously, as applied in the Contract Law, the reliance deals with the state of mind of the deceived party in the situation where a fraud occurs. But for the purpose of recovery, there must exist the connection between deceptive conduct and reliance. As one view argued, two factors are critical in determining the reliance. The first factor is the relationship, that is, the misrepresentation or false information must be closely related to the contents of the transactions, without which the reliance would not stand. The second factor is the cause of misunderstanding, which means that the misunderstanding of the deceived party is a direct outcome of the induction of the deceiving party, not a result of the deceived party's own fault.[46]

Mistaken Manifestation of the Will of the Deceived

Many Chinese contract scholars believe that the mistaken manifestation of the will of the deceived party is an essential element for actionable fraud. At first glance, it seems to be a repetition of reliance. The emphasis, however, is not on the reliance itself or the state of mind of the deceived party but the actual result of the reliance or the action of the deceived party. The idea is that the misunderstanding of the deceived party, without more, would not make the fraud actionable because if the deceived party does not take any action resulting from the misunderstanding, the fraud would end without producing any consequences that the law will readdress. The action required is that the deceived party mistakenly manifested his will to enter into a contract with the deceiving party and the contract was concluded accordingly.

Thus, the mistaken manifestation of will implicates the action of the deceived party who is induced to enter into contract or undertake transactions with the deceiving party, and such action is taken in reliance upon the fraudulent conduct of the deceived. More to the point, to determine the mistaken manifestation of the will of the deceived is to establish the causation. The underlying rationale is that because to hold the deceiving party liable for fraud, it must also be proved that the deceived party was in fact deceived by the misrepresentation or fraudulent conduct of the deceiving party, and relied on it to enter into the contract.

It is true that as the elements for finding fraud, the reliance and mistaken manifestation of the will of the deceived may seemingly be overlapping. But the difference between the two could be simply described as follows: the element

[46] See Wang Liming, *supra* note 7, at p. 642.

of "reliance" deals with the question whether the deceived party is willing and has the reason to rely on the misrepresentation; but the element of "mistaken manifestation of the will of the deceived" involves the matter as to whether the deceived party has in fact relied on the misrepresentation.

Once again, as we have indicated, under the Contract Law, a contact is void for fraud only if the fraud has caused harm to the State interest. Alternatively speaking, other than the harm caused to the State interest, a fraud will not necessarily lead to the voidness of the contract.

3.1.2. *Duress*

It is a general understanding that duress occurs where the "free will" of a party is overcome by wrongful act or threat. The Contract Law does not specify what would amount to the duress, but an interpretation of the Supreme People's Court is widely regarded in China as the test for determining the existence of duress. According to Article 69 of the Supreme People's Court's "*1998 Opinions on Implementation of the General Principles of Civil Law of the People's Republic of China (Provisional)*, the threat to damage the life and health, honor, reputation or property of the citizen or his relatives or friends, or to damage the honor, reputation or property of the legal person in order to force the other party to make manifestation that is against his true will shall be deemed as duress.[47]

Based on the interpretation of the Supreme People's Court, duress, in the context of contract, is then defined as a threat to inflict personal or property damages, which causes the fear in the mind of the other party, under which the other party is coerced to enter into a contract. Note that in China, for the purpose of finding duress, the personal and property damages not only include the damages to the contractual party himself but also include those caused to the relative or friends of the party. The fundamental issue is whether the will of the contractual party in question has been overcome to the extent that a contract is entered against his will. It is clear that the test set forth by the Supreme People's Court is a subjective one. And as a result, the question whether a reasonable person would be in fear under the same or similar circumstance is of no significance, if not irrelevant.

It has been argued that the threat under the Contract Law comprises two situations. One situation is the threat to cause damage. In this situation the damage so threatened may happen or may not happen because it is a "to do" threat. Thus, to determine whether there exists a threat under this circumstance it is important to see if the party in question really believes that the damages are

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[47] See Supreme People's Court, *Opinions*, *supra* note 9.

going to happen. If however, the party does not think that there would be any damage, there will be no threat because the party to whom the "to do" threat is made is not in fear. The other situation is the threat actually facing the party, such as infliction of violence, withholding a piece of property, or defaming. The threat as such is a "doing" threat, which has been or is causing the fear to the party.[48] The point is that a "doing" threat is of course a threat, but a "to do" threat may not really be a threat depending on the state of mind of the party to whom the threat is made.

Duress in China is generally considered to consist of 4 elements. The first element is the intent to coerce. The intent is found where the coercing party knows that his conduct will create fear in the mind of the other party and intentionally does so in a hope that the other party will have no choice but to do what is asked. To determine the intent, the outcome expected by the coercing party through the means of coercion is decisive. But from the viewpoint of many Chinese contract scholars, the outcome does not include the actual benefits or interests the deceiving party would get because seeking benefits or interests only reflect the motivation, not the intent, of the coercing party.

The second element concerns the act of coercion. As the Supreme People's Court pointed out, to constitute duress, there must be a threat to cause harm or damage to person or property. The threat, as we have discussed, is the action that the coercing party is taking or will take to overcome the free will of the other party so that the other party will have to enter into certain transaction involuntarily. However, there is a debatable issue concerning the degree of the threat, and two tests in this regard have been introduced. The first one is the "fear" test. Under the fear test, the threat will be found if the coerced party is in fear as a result of the act of coercion taken by the coercing party. The second test is called the "material" test. According to the material test, the finding of threat would not be sufficient unless there is a material harm or damage to be caused. The proponents of the material test argue that the fear resulting from the threat will exist only when the act of coercion is material (grave) enough.

The third element involves the wrongfulness of the coercion. In order to make a case for threat, it must be proved that the coercion has no legal base or serves an illegitimate purpose. A commonly acceptable dictum in China is that threat to exercise legal rights that are granted by the law should not be deemed as duress unless such rights are clearly abused. For example, a threat to bring a lawsuit to ensure that the legitimate rights of the party will be effectively protected in the transactions is obviously not an actionable duress.

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[48] See Wang Liming & Cui Jianyuan, *supra* note 43, at pp. 271–272.

If, however, a threat to bring a lawsuit is used to achieve the purpose beyond the rights legally granted, the threat may become duress. Perhaps because of the concerns about abuse of rights in the case of threat, some Chinese contract law scholars strongly advocate that the threat to exercise legal rights should be regarded as duress if its purpose is found illegal.[49]

The forth element is the causation, which requires that the fear be a real and natural result of the threat inflicted. That is to say that to find duress, the threat has to be the one having caused the coerced party to fear that the harm or damage threatened is so imminent and serious that he would have no other alternative, and under this fear the contract is concluded according to the terms and conditions produced by the coercing party.[50] Therefore, two factors are decisive for finding the causation: presence of fear and direct result of fear. The questions that must be answered are whether the threat has led to a fear and whether a contract or transaction has been entered into because of the fear. Any broken chain in this regard will necessarily defeat a finding of the duress.

In order to help the courts better handle the cases involving fraud or duress in practice, a group of judges at the Supreme People's Court made interesting comments on how to differentiate fraud from duress. According to those judges, the distinctions between fraud and duress can be discerned from several perspectives. First, in the case of fraud, the contract at least on its face is made voluntarily between the deceiving party and deceived party, but in duress, the coerced party is under fear to make the contract that is against his will. Second, the contents that are sought by the deceiving party may become part of the contract, while the fear of the coerced party could not be seen in the contract. Third, fraud may be made by either action or omission, but duress may only be made through active conduct. Forth, the fraud in contract is the conduct of a contracting party, while the duress, however, may be imposed upon a contracting party by a third person.[51]

Like the case in fraud, for a contract to be void for duress, the harm to the State interest must be present and proved. Or otherwise, the contract made under duress will be regarded voidable.

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[49] See Wang Liming, *supra* note 7, at pp. 646–647.

[50] This element reflects China's acceptance of the provision of Article 3.9 of UNIDROIT's "Principles of International Commercial Contracts, which provides: "A party may avoid the contract when is has been led to conclude the contract by the other party's unjustified threat which, having regard to the circumstances, is so imminent and serious as to leave the first party no reasonable alternative. In particular, a threat is unjustified if the act or omission with which a party has been threatened is wrongful in itself, or it is wrongful to use it as a means to obtain the conclusion of the contract."

[51] See Li Guoguang, *supra* note 28, at pp. 226–227.

3.2. Malicious Collusion to Damage the Interests of the State, a Collective or a Third Party

In China, a contract is void if it is concluded under a malicious collusion to cause harm to the State, a collective or a third party's interests.[52] The collusion refers to the deliberate collaboration of a party with the other. Under the Contract Law, if the collusion leads to a contract between the parties, which is purposed, or contains contents, to damage the interests of the State, a collective or a third party for the illegitimate benefits or gains of the parties in collusion, the collusion will be found malicious or in bad faith.[53]

Therefore, in the concept of the Contract Law, malicious collusion is a civil conspiracy through the form of contract to achieve illegitimate goals. For example, a malicious collusion will present if a bidder conspired with the bidding inviter to ensure that the bidder will get the contract by pushing out other competitors. Another example of malicious collusion is that a representative of State owned enterprise collaborates with the other party in a contract to sell the products of the enterprise at the unreasonably low price in exchange for certain benefits the other party has brought or may bring to the said representative.

Obviously, the key elements of malicious collusion are "collaboration" and "bad faith". The collaboration has a two-layer meaning. At first layer, the parties involved have an agreement aimed at carrying on intended act with each other. The agreement may be in the form of either words or conduct. The second layer is that the parties collaboratively take action together to achieve the goal underlying the agreement. Whether the goal has actually been achieved does not affect the finding of the collaboration. The bad faith implicates the knowledge and deliberation of the parties who collaborates. If the parties know that their collaborative conduct is causing or will cause harm or damage to the State, a collective or a third party's interest, and deliberately make it happen, they are in bad faith.

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[52] It is interesting to note that that Contract Law differentiates the State and collective from third party, which is criticized to treat the equal civil actors unequally. The argument against such wording is that as opposed to contract parties, both State and collective are all third parties.

[53] As noted, in China, the public ownership is divided into two categories: State ownership and collective ownership. Article 6 of Chinese Constitution (as amended 2004) provides that the basis of the socialist economic system of the People's Republic of China socialist public ownership of the means of production, namely ownership by the whole people and collective ownership by the working people". Under Articles 73 and 74 of the 1986 Civil Code, State property shall be owned by the whole people and property of collective organizations of the working people shall be owned collectively by the working people. Most collectives are rural collectives, i.e. farmers production associations.

Thus, under the Contract Law, where a recovery for malicious collusion is sought, both collaboration and bad faith must be proved. But as is the case in practice, it seems very difficult to obtain the evidence that the parties collaborated in bad faith because the collaboration between the parties might not be discernable. On the other hand, a contract made through malicious collusion will be void only if the contract is purposed to damage the interests of the State, a collective or a third party. And then the claiming party has the burden of proof for both the intended or actual damage to such interests.

3.3. Use of Contract for Illegal Purpose

A contact, though legally concluded, is also null and void if it is intended to serve an illegal purpose. The difference between the malicious collusion to damage the State, a collective or a third party's interests and the use of contract for illegal purpose is that the former deals the means of making the contract and its consequences, while the latter involves the legitimacy of purpose that the contract is made for.

In the case where contract is entered for a concealed illegal purpose, the form of the contact and the contract itself on their face are valid or legally permissible, but the goal that the contract is actually to achieve is illegal or prohibited by the law. To illustrate, assume the parties make a contract to voluntarily transfer of a piece of property between them, the contract, if not prohibited by the law with regard to the transferred property, would be valid and effective. But if the transfer of property is aimed at evading tax or payment of debts, the contract will be deemed as having concealed an illegal purpose (tax evasion or cheating) and therefore is void.

Pursuant to the Contract Law, the essential factor to determine whether an illegal purpose is concealed under a contract is the intent of the parties because from the outside, there is nothing wrong with the contract. Thus, if the parties intend to evade law or legal obligations through a legitimate contract, it would be held that there exists a concealed illegal purpose. The intent could also be inferred from the actual consequences resulted from the contract, for example, the frustration of the debt payment as a result of contractual transfer of the property by the debtor.

However, a question would be raised in the finding of concealed illegal purpose when one contractual party has the intent to conceal and the other party has no knowledge about it. The question is whether the innocent party should be compensated if the contract is held void for its concealing illegal purpose. For instance, a thief entered into a contract with a student to sell a used bicycle to the student for RMB 200 Yuan. The purpose of the thief for making the contract was to transfer the stolen good – the used bicycle – to the student for money and the student knew nothing about it. Clearly, the contract itself was

fine but the illegal purpose – transfer of the stolen good – was concealed. Should the student be able to get his RMN 200 Yuan back if the contract was declared void when the stolen bicycle was discovered? What if the thief spent the RMB 200 Yuan already? There seems to have no readily answer in China to this question yet.

Another matter involves damages. Of course, the use of contract to serve illegal purpose may or may not cause actual damages to other party. Nevertheless, under the Contract Law, to determine whether an illegal purpose is concealed under the color of a contract, the presence of actual damages is not required. Therefore, to the finding of illegal purpose under the guise of a contract, the question whether there have been any damages is not a concern. However, when determination of the liabilities to be imposed becomes an issue, the actual damages have significant relevancy.

3.4. Harm to the Social Public Interest

As discussed in Chapter IV, the protection of social public interest is a stated contract principle in China that directly affects the validity of the contract. This is a typical contract area where the freedom of contract is interfered with by the government for the interest of the public. Simply speaking, under the Contract Law, a contract, though freely concluded by the parties, may not be enforced if it offends the social and public interests that the government intends to protect.

According to Article 7 of the Contract Law, when a contract is concluded or performed, no social public interest may be damaged. In addition, it is mandated in Articles 55 of the Civil Code that a civil conduct shall not violate social public interest. Further, Article 58 of the Civil Code provides that a civil conduct is null and void if it violates the social public interest. In China, the term of social public interest and the term of public policy are often interchangeably used in contract cases. But as we have indicated, the social public interest in China is regarded to connote both public order and social virtues.

To speak fairly, social public interest is a very broad concept and is difficult to be precisely defined. A tough question is perhaps the one as to what would constitute a social public interest. There are several efforts that have been made in China by the scholars who try to (a) offer a scholarly guidance on the list of conducts that would violate the social public interest and (b) make a distinction between public social interest and State and private interest. For example, as one view argued, the social public interest mainly refers to the interest of all members of the society. In contrast, the State interest is the interest that the State as a governing body enjoys, and the private interest is the interest of particular member of the society.[54]

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[54] See Wang Liming, *supra* note 7 at pp. 652–653.

In many cases, the social public interest is being reflected in statutes. As a result, the social public interest is often intertwined with the issue of legality of the contact. If a statute clearly prohibits the parties from making certain contract that would be in violation of a particular social public interest, there will then be a case that combines both social public interest and legality. The unfair competition law may serve as a good example in this regard. The very purpose of the unfair competition law is to create an environment in which the business operators will deal with each other fairly. Hence, if a contract is purposed to impose unreasonable restriction on competition, the contract not only may violate unfair competition law itself but also would be contrary to the social public interest of fair competition embodied in the law to promote the welfare of the general public.

In addition, a contract may be deemed null and void for damaging social public interest even if it violates no provision of the existing laws or regulations. It is particularly true when the social virtues are involved, over which the laws may have limited coverage. On the other hand, due to the wide range of the social and public interest, not every violation of such interest would render the contract void. Under the Contract Law, a contract would be void for violation of social public interest only if such violation would damage the public order and important social virtues.

3.5. Violation of Compulsory Provisions of Law or Regulations

A contract that violates the compulsory provisions of law is a matter of illegality. If a contract is found to have violated the law, the contract is void and has no effect from beginning. In China, the violation of compulsory provisions is separated from the use of contract for illegal purpose because it is believed that the issue of illegality differs from that of the use of contract for illegal purpose. The major difference is described to be that the illegality directly involves the subject matter or the contents rather than the underlying objective of the contract. A few contract scholars in China also argue that the illegality under the Contract Law shall in addition include violation of the formality mandated by the law or regulations. In their view, for example, if a contract is required to be approved under the law, without such approval the contract will be void because violation of the approval requirement will make the contract illegal in its formality.

With regard to the scope of illegality, the Contract Law takes a narrower or more restrictive approach than the 1986 Civil Code. Under Article 58 of the Civil Code, a civil conduct will be invalid if it violates the law. The Contract Law, however, limits the law to the compulsory provisions of the law. In other words, a contract will be null and void only if it violates the provision of the law that is imperative. In terms of their effect, the provisions of the law could

be divided into two categories: mandatory provisions and non-mandatory provisions. A provision of law is mandatory if it is denoted by the word such as "should", "must", "shall", or "prohibited". If the provision is phrased with the word "may", "could" or "allowed", the provision is deemed non-mandatory.

Thus, under the Contract Law, to make a contract void for illegality, it must be proved that the contract violates the mandatory provision of the law. A both debatable and practical issue, however, is what would be the "law" for purposes of making a contract void. The very center of the issue is whether the local law should be included as the "law". Many argue that the law shall mean the statute passed by the national legislature and the administrative regulations adopted by the national government, excluding any local law or regulations because the Contract Law makes no indication about application of any local law or regulation in this regard.[55] But some point out that despite the disputes over the "law", if a contract contradicts the local law or regulations, it may be deemed void on the ground of harm on social public interest. Obviously, the issue whether the violation of the local law or regulations would make the contract void remains unsolved.[56]

As described in the introduction of this book, China has a unified legal system with an exception to Hong Kong and Macao because of the historical status of these two regions. Under the Chinese Constitution (as amended 2004), the primary legislative power rests with the National People's Congress. The National People's Congress (and its Standing Committee) is responsible for adopting and amending national laws. The executive branch, namely the State Council and its ministries, is empowered to stipulate regulations and rules of administrative nature at the national level. In addition, the people's congresses the provincial level (including municipalities directly under the central government) and their standing committees have the power to make local law and rules that do not contravene the Constitution, national laws or administrative regulations.

Given the strong likelihood of local government to protect the local interests, one should not underestimate the possible influence of local law and regulations on the validity of contract. Since the local courts are all required to report to the local people's congress and the courts budgets are provided by the local government, it is not uncommon to see that the court decisions are more

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[55] See Wang Liming & Cui Jianyuan, *supra* note 43 at pp. 278–279; Jiang Ping et al, *A Detailed Explanation of the Contract Law of Law*, 43 (China University of Political Science and Law Press, 1999); Yang Lixin et al, *Implementation and Application of the Contract Law of China*, 87–88 (Jilin People's Publishing House, 1999).

[56] See Su Haopeng, *supra* note 13 at 285.

driven by local interests. Therefore it would not be surprised that a contract violating local law or regulations is deemed void locally because of the concern for the local interests.

4. Voidable Contracts

It must be kept in mind that under the Contract Law, a contract will be void if there is a fraud or duress that has caused harm to the State interest. If, however, no State interest is involved, the fraud or duress will only render the contract voidable. Once again, the underlying premise is the supremacy of the State interest in Chinese economy. As far as the contract is concerned, the major difference between void contract and voidable contract is that when a contract is void, it will take no effect without any action of the parties, but if a contract is voidable, the party seeking to avoid the contract must make a request.

In accordance with Article 54 of the Contract Law, if a contract is concluded by a party against the other party's true intention through the use of fraud, coercion or exploitation of the other party's unfavorable position, the injured party shall have the right to request the people's court or an arbitration body to modify or rescind the contract. Article 54 also provides that a party shall have the right to modify or rescind a contract if the contract (a) is concluded as a result of a material misunderstanding or (b) is obviously unfair at the time of contract.

Thus, the provisions of the Contract Law implicate that a contract is voidable in China under any of the following five situations: fraud, duress, exploitation of other party's precarious position, material misunderstanding or obvious unfairness. It is important to recapitulate that a contact is voidable for fraud or duress only if it causes no harm to the State interest, or otherwise it will be void.

According to the Contract Law, for a contract that is voidable, the injured party may have two alternatives: to modify the contract or to rescind contract. In either case, the injured party must make a request. Although a court or arbitration body may under the request of injured party rescind or modify a contract, the contract may not be rescinded if the injured requests for modification. The rationale is that a contract is the product of the free will of the parties and their voluntary and meaningful choice in deciding their contractual rights and obligations ought to be respected as much as possible.

But in order to prevent abuse of the right to rescind a contract on the ground of voidalbleness, the Contract Law in particular singles out two circumstances under which the right to request for a rescission of the contact will be extinguished. The first one is the one-year time limitation. Article 55 of the Contract Law requires that the party having the right to rescind the contract exercise the right within one year from the day he knows or ought to know the

causes for rescission.[57] A failure to comply with the one-year time limitation will extinguish the right to rescind. The other one is the waiver of the right. Under Article 55 of the Contract Law, the right to rescind a contract will also be exterminated when the party who has the right to rescind explicitly expresses or acts to waive the right after he knows the causes to rescind.[58]

4.1. Exploitation of the Other Party's Precarious Position

In the context of the Contract Law, the exploitation of other party's precarious position means to take advantage of the other who is in a difficult situation (e.g. in an urgent need or a desperate situation) in order to seek unjustified benefits or make an unfair deal. According to the Supreme People's Court, it shall be deemed as taking advantage of the other's difficult situation if a party with a purpose to seek illicit benefits compels the other party who is in difficulty to make a manifestation against his true will, whereby the other party's interest is seriously impaired.[59]

The prevention of a party from exploiting the other who is in difficulty is based on the notion that taking advantage of the other's precarious position would vitiate consent to a contract and seriously undermine voluntary choice of the parties. In 1986 when the Civil Code was adopted, the legislators took the position that a contract made by taking advantage of the other party's difficulty was void, and this position was fully reflected in Article 58 of the Civil Code. It was then argued, however, that it would be overly restrictive and arbitrary to make void a contract resulting from a party's taking advantage of the other's difficulty because pursuant to the idea that a contract is mainly a matter between the parties it would be more appropriate to allow the injured party to decide how to proceed with such contract. Consequently, the Contract Law alters the provision of the Civil Code and makes the contract voidable if made by taking advantage of the other's difficult situation.

But, the question is how to define the difficulty or difficult situation. Under the Supreme People's Court interpretation, the difficulty may refer to an urgent need or a desperate situation. A general view in China is that the exploitation of the other's unfavorable position is something that would not possibly happen under a normal circumstance and therefore need to be determined objectively. For this purpose, a four-factor test is advanced and accepted by many.

The first factor is the fact of difficult situation facing the other party. Because of existence of the difficult situation, a party has the opportunity to take advantage of the other and to push through a deal that the other party would

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[57] See the Contract Law, art. 55.

[58] See *id*.

[59] See Supreme People's Court, *Opinions*, *supra* note 9.

otherwise not accept. The second factor involves the action of exploitation. There must be some conduct or certain words through which a party compels the other party to make an involuntary choice against the latter's true intention. As a factual matter, the action of exploitation is a two-sided issue. On the one hand, the exploitation is in fact undertaken, and on the other hand, the exploitation ultimately results in the other party's surrender of his free will. The third factor concerns deliberateness of exploitation. The party taking advantage of the other knows that the other party is in a difficult situation and deliberately makes the other party to have no choice but to accept a deal against his will. Thus, the exploitation may not be found if the other party has alternatives despite the difficulties he has encountered. The forth factor is the damage to the other party, which means the terms and conditions the party has to accept to his disadvantage. It is true that the exploitation may benefit the exploiting party, but what is important is whether the other party has suffered damages as a result of the exploitation.

From the viewpoint of Chinese contract law scholars, the urgent need means an imminent want for something to live through the difficulty, which includes both economic need (e.g. money) and want for living (e.g. service). The desperate situation concerns not only the economic constraints but also the hardship in life, health or reputation. It is then clear that the economic compulsion or pressure is recognized in China as the ground to make a contract voidable under the category of exploitation of the other's unfavorable position. Although there are similarities between exploitation and duress (e.g. lack of meaningful and voluntary choice), the major difference is that duress involves illegal threat or wrongful coercion, while in exploitation the exploiting party engages in no illegal or wrongful conduct but taking advantage of the other.

4.2. Material Misunderstanding

It is interesting to note that in China the term "misunderstanding" rather than "mistake" is used as a legal reason for which a contract becomes voidable. Many insist that "misunderstanding" is a concept different from "mistake" because misunderstanding deals with the contract itself while the mistake has to do with the fact on which the contract is based. The main point is that the existence of the mistake does not impede the parties from reaching the consent on the contract.[60] Opponents argue that misunderstanding actually means

[60] According to Professor Wang Liming, misunderstanding differs from mistake in several aspects: (a) the concept of mistake has a broader coverage than that of misunderstanding; (b) mutual mistake shall make a contract void, but misunderstanding will only render the contract voidable; (c) mistake may be a unilateral or mutual mistake for which there will be a different consequence while misunderstanding contains no such distinction. See Wang Liming, *supra* note 7 at pp. 683–684.

the mistake that is made by the parties in making the contract and because the result would be the same, those two terms should be deemed as the same though they are named differently.

Despite the arguments, there seems to have no practical significance to specifically draw a line between misunderstanding and mistake. Actually in many people's courts the misunderstanding is generally referred to mean mistake. In a recurring fact pattern, the people's courts prefer to define the misunderstanding as the mistake that the parties make in cognizance of factual elements of the contract.[61] Also, in the drafting of the Contract Law, misunderstanding was interpreted as the situation where the parties made mistake or had no knowledge about the incompatibility (or imparity) between their intentions and actual facts or outcomes.[62] A more direct interpretation is to characterize misunderstanding as the term equivalent to the mistake commonly used in western contract law theory.

There are three factors that are regarded important to constitute a misunderstanding. The three factor are: (a) an error in expression of intention; (b) negligence causing the error; and (c) causation between the contract and the erroneous expression of intention. Under Article 54 of the Contract Law, however, a contract is voidable for misunderstanding only if the misunderstanding is material. The materiality requirement set forth in the Contract Law derives from Article 59 of the 1986 Civil Code. In Article 59 it is provided that a party shall have the right to request a people's court or an arbitration body to alter or rescind a civil act if the act is conducted with a material misunderstanding of the contents of the act.[63] But Article 54 of the Contract Law emphasizes that to render a contract voidable there should exits material misunderstanding during the formation of a contract.[64]

But, neither the Civil Code nor the Contract Law contains any provision as to what misunderstanding would amount to be material. Attempting to resolve this matter, the Supreme People's Court has provided sort of guidance for the people's courts to follow in their practice. In the opinion of the Supreme People's Court, the misunderstanding is material when a party misunderstood the nature of conduct, the other party, and the type, quality, specification and quantity of the objects in question, which results in a consequence contradictory to his true intention and causes him relatively serious losses. Obviously the Supreme People's Court tried to solve the materiality issue through its

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[61] See Li Guoguang, *supra* note 28 at pp. 231–232.
[62] See Sun Lihai, *supra* note 33 at p. 152.
[63] See the 1986 Civil Code, art. 59.
[64] See the Contract Law, art. 54.

interpretation. But in the meantime, its imbedded cautiousness in the awkward wording of the interpretation complicated issue by requiring a proof of "relatively serious losses." The question that will necessarily be raised is what losses would be relatively serious.

Nevertheless, the Supreme People's Court's interpretation established a content-based test for the finding of material misunderstanding. Then, to determine material misunderstanding, it is critical that the misunderstanding involves the contents and nature of the contract, the other party, or the type, specification or the quality of the objects of the contract. What seems interesting is the misunderstanding of the other party. This is to mean that the mistaken party negligently erred in the other party's qualification or skills for performing certain contract. Often the case involving the misunderstanding of the other party is the service contract where the other party's "personal qualification" is at issue.

The rationale underlying the interpretation of the Supreme People's Court with regard to material misunderstanding is that the misunderstanding is material if it affects the basic rights or obligations of the parties or the very purpose of the contract. Under this rationale, the people's courts may not find a misunderstanding material enough to make a contract voidable if a party misunderstood only the quantity, means of performance, location of performance or time period of performance, unless the contractual rights or obligations or the purpose of the contract present are adversely affected.[65]

A seemingly unsolved question is whether the material misunderstanding could be a mutual one. The interpretive dispute over this question is whether a contract is voidable for material misunderstanding in case where the parties each made erroneous expression of intention by mistake when making the contract. As noted, there has been a disagreement among Chinese contract scholars on the distinction between misunderstanding and mistake. Several argue that misunderstanding, as a ground for voidable contract, does not contain a mutual misunderstanding because it refers to the error in manifestation of the intention of a party, and a mutual misunderstanding, if any, would make a contract void not voidable. In practice, the people's courts prefer to hold that like a mistake, misunderstanding could also be either unilateral or mutual.

Also questionable is whether the misunderstanding relating to law existing at the time of contract would give a party the right to avoid a contract. In many western countries, a mistake of law has the similar effect as a mistake of fact in terms of rendering a contract voidable. In the United States for example, a well-accepted contract principle is that a relief is available for mistake of law

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[65] See Li Guoguang, *supra* note 28 at p. 233.

when contract was concluded.[66] A same principle is adopted in UNIDROIT's Principles of International Commercial Contracts, according to which mistake is an erroneous assumption relating to fact or to law existing when contract was concluded.[67] In China, however, it may be inferred at least from the Supreme People's Court's interpretation that the misunderstanding relating to law is not a ground for avoiding a contract.

4.3. Obvious Unfairness

In China, a contract is also voidable if it is found to be obviously unfair at the time of contract. An obviously unfair contract is the contract in which there is a gross disparity between the rights and obligations of the parties as a result of violation of the principle of fairness of the Contract Law. According to the Supreme People's Court, a contract is obviously unfair if a party uses his superiority or dominant position or takes advantage of the other party's inexperience to make the unbalance of rights and obligations between them so obvious that the principles of fairness and equal bargain are clearly offended.[68]

Indeed, the obvious unfairness is aimed at protect a party normally in a weak position from being unfairly treated by the other. Following the Supreme People's Court interpretation, scholars almost unanimously classify the obvious unfairness to include three major components. First, there is a clear imbalance between the rights and obligations of the parties. If a party bears obligations excessively over the rights he may have or at a cost of huge losses to him, and the other party is overly benefited, the rights and obligations of the parties would obviously be found imbalanced. Second, there is the situation where injured party was in desperate situation or lack of experience at the time of contract, and the other party took advantage of such desperate situation or inexperience of the injured party and made the contract at the suffering of the injured party. Third, the imparity between the rights and obligations of the parties was present at the time the contract was concluded.

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[66] Such a principle is regarded in the United States as an import from criminal law. In criminal law, ignorance or mistake as to a matter of law is a defense if the ignorance or mistake negatives the purpose, knowledge, belief, recklessness or negligence required to establish a material element of the offense. Model Penal Code, § 2.04(1).

[67] See UNIDROIT's Principles of International Commercial Contracts, art. 3.4 (Definition of mistake). In the official comment, it is further indicated that this article equates a mistake relating to facts with a mistake relating to law. Identical legal treatment of the two types of mistake seems justified in view of the increasing complexity of modern legal systems.

[68] See Supreme People's Court, *Opinions*, *supra* note 9. The term "equal bargain" is normally translated as "to make compensation for equal value." It means that when making a contract, what a party bargained for should be fairly equal to what he paid for.

Apparently, the notion of the obvious unfairness does not include any risk commonly associated with business operations. Therefore, any imbalance, caused by the change of market situation (e.g. rise or fall of price), between the rights and obligations of the parties after the conclusion of the contract will be deemed as normal business risk for which no relief will be granted with regard to the effect of contract.[69]

But, the obvious unfairness seems to be intertwined at least in part with exploitation of the other party's precarious position because they are all involved in taking advantage of the other. A closer look at the two, however, may help distinguish them. Unlike obvious unfairness, the exploitation of the other party's precarious position has a clear focus on the difficulty facing the other party. In the case of obvious unfairness, the other party may not necessarily in a difficult situation although he may desperately need something. In addition, what matters in finding obvious unfairness is the existence of imbalance between the rights and obligations of the parties, while exploitation of other party's precarious position mainly concerns the bad faith of a party in taking advantage of the other's difficulty situation for benefits. Moreover, the obvious unfairness is closely related to the superiority of a party over the other or inexperience of the other party, but the exploitation of the other party's precarious position primarily deals with the other party's facing difficulty regardless of superiority or experiences.

Because of its emphasis on imparity between rights and obligations, the obvious unfairness, as many argued, may only apply to onerous contracts (obligation in exchange for benefit), particularly bilateral contracts. If a contract is unilateral or gratuitous (*nudum pactum*), there is no need to compensate the parties with each other, and then the issue of imparity between the rights and obligations of the parties becomes irrelevant.[70] The basic idea of obvious unfairness is that in order for a contract to be protected by the law, it should be a fair dealing between the parties as a result of their free and voluntary choice.

Although the Supreme People's Court has specified in its interpretation what would constitute obvious unfairness, many still feel that it is necessary to further define what unfairness would be deemed "obvious". It is true that under both the Contract Law and the interpretation of the Supreme People's Court, to avoid a contract for unfairness, the unfairness must be obvious. The question is how to determine whether unfairness is obvious. One proposition is that the unfairness is obvious if the gain of a party by unfair means exceeds

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[69] See Wang Liming & Cui Jianyuan, *supra* note 43 at pp. 285–289; See also Yang Lixin, *supra* note 55 at pp. 93–94.

[70] See Li Guoguang, *supra* note 28 at p. 233. See also Jiang Ping et al, See also Jiang Ping, *supra* note 55 at p 45.

the limit by the law. For example, in an employment contract, if the salary agreed to pay an employee is far below the level in the same or similar sector or industry, such contract with regard to the salary payment would very likely be deemed as obviously unfair.[71]

Some scholars in China equate the obvious unfairness with the concept of unconscionability in the US contract law. Under the UCC, if a contract is found to have been unconscionable at the time it was made, the court may refuse to enforce the contract.[72] The basic test for unconscionability, as articulated by the official comment of the UCC, is the one-sidedness in the light of the general commercial background and the commercial need of the particular trade or case. If the one-sidedness is to mean the disparity between the rights and obligations of the parties, the unconscionability and obvious unfairness have the commonality, and they both are the policy-driven mechanism to protect against unfair or unconscionable exercise of a legal right.

But, the concept of obvious unfairness in Chinese contract law seems to have a more broader meaning than that of unconscionability. In certain cases a contract that may be deemed unfair may not be unconscionable. For example, if a contract is made by a party who is lack of experience, the contract may smell bad if the inexperience is unfairly exploited by the other party, but the contract may still be a conscionable one. Also, the doctrine of unconscionability is purposed to prevent two evils: "oppression and unfair surprise".[73] The obvious unfairness, as mentioned several times, is more concerned about balance of the rights and obligations of the parties.[74]

Another point worth mentioning is the doctrine of undue influence. The Contract Law contains no such doctrine nor has the doctrine yet been accepted in China. In the view of many Chinese contract law scholars, the problem of

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[71] See Wang Liming, *supra* note 7 at 692. In his book, Professor Wang listed the gain exceeding the limit of the law as a factor to find obvious unfair contract.

[72] UCC § 2-302 reads as follows:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

[73] See Calamari & Perillo, *supra* note 12 at 373.

[74] As seen from the interpretation of the Supreme People's Court, the concept of obvious unfairness is adopted in the Contract Law with a reference to the approach of gross

undue influence could be dealt with either under the provision of duress or the provision of obvious unfairness of the Contract Law. But many point out that since the undue influence refers to the situation where a party, by using his special relationship with the other party or his special status, imposes pressure on the other party during the contract making process, it is more likely to constitute an obvious unfairness than duress.

5. Consequences of Void and Voidable Contracts

Once again, when a contract becomes void, the contract is of no effect from the very beginning. If a contract is voidable, the effectiveness of the contract is not affected until the contract is avoided and such avoidance takes effect retroactively. The issue that follows the avoidance in either a void or viodable contract is the restitution or compensation to one party or to each other of the parties. In dealing with the consequences of the void and voidale contracts, the Contract Law adopts a number of principles that are acclaimed to be compatible with internationally accepted rules, as reflected mainly in the provisions of UNIDROIT's Principles of International Commercial Contracts and the United Nations Convention on the International Sale of Goods.

5.1. Avoidance from very beginning

It is provided in Article 56 of the Contract Law that a contract that is null and void or rescinded shall have no legal binding force ever from the very beginning. A contract having no legal binding effect means that the contract is ineffective and shall not be enforced. Therefore, after the contract is avoided, the contractual relationship between the parties ceases to exist. Note that since avoidance occurs after the contract was concluded, it may be made before, during or even after the performance. But whenever the contract is avoided, the avoidance takes effect from the time that contract was concluded.

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disparity in Article 3.10 of UNIDROIT's Principles of International Commercial Contracts. Article 3.10 provides that:

(1) A party may avoid the contract or an individual term of it if, at the time of the conclusion of the contract, the contract or term unjustifiably gave the other party an excessive advantage. Regard is to be had, among other factors, to

(a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent need, or of its improvidence, ignorance, inexperience or lack of bargaining skill. . . .

5.2. Partial avoidance not affecting the remaining part of the contract

What happens in reality is that in many cases, a contract as a whole is not void or voidable but certain clauses or terms of the contract are. In other words, only part of the contract becomes void or voidable. A general principle is that the partial avoidance of a contract is recognized and permitted. As provided in Article 3.16 of UNIDROIT's Principles of International Commercial Contracts, where a ground of avoidance affects only individual terms of the contract, the effect of avoidance is limited to those terms unless, having regard to the circumstances, it is unreasonable to uphold the remaining contract. The Contract Law follows this principle by providing that if part of a contract is null and void without affecting the validity of the other parts, the other parts shall still be valid.[75]

There is an argument that the partial avoidance of a contract under the Contract Law shall meet two requirements. One requirement is divisibility of the contract. The point is that if a contract is indivisible, the avoidance, though partially, will still affect the whole contract. In this regard, the divisibility means that the individual terms of the contract may stand independently from each other. One typical example is the disclaimer clause. As we have discussed, in accordance with Article 53 of the Contract Law, a disclaimer is void and null if it is purposed to exempt the liability for personal injury to the other party or the property damage to the other party as a result of deliberate intent or gross negligence. If a contract contains a disclaimer clause in this nature, the people's court will take the clause out of the contract so that the contract will remain valid because the disclaimer clause is normally independent from other parts of the contract.

The second requirement involves possibility of partial performance. If an individual term is avoided, the avoidance shall have no direct impact on the validity of remaining part of the contract, and after the avoidance, it is still possible for the parties to perform the valid part of the contract. If, however, the void term, though divisible, is so closely related to other part of the contract that the avoidance would make it meaningless to have the contract, or unreasonable to continue performing the contract. Similarly, if it is found that after avoidance of the individual term, the rights and obligations of the parties are grossly imbalanced, the rest part of the contract may not be enforced because of the fairness concerns.

5.3. Independence of Dispute Settlement Clause

The Contract Law treats the dispute resolution clause in the contract as a special and separate clause, which means that the dispute settlement clause will

[75] See Article 56 of the Contract Law.

remain intact regardless of the legal effect of other clauses in the contract. Under Article 57 of the Contract Law, if a contract is null and void, rescinded or terminated, the validity of the dispute settlement clause independently existing in the contract shall not be affected. Here, the independence is described to mean three things: (a) when the contract is avoided, the dispute settlement clause remains effective; (b) if the contract is rescinded, the rescission does not apply to the dispute settlement clause; and (c) in case the contract is terminated, the effectiveness of the dispute settlement clause shall stay unchanged.[76]

The independence of dispute settlement clause has a practical importance with regard to the validity of the contract. Assume that a contract dispute is brought to a court, and the court jurisdiction is established on the dispute settlement clause. After the hearing, it is found that the contract is void and the avoidance shall apply retroactively to the time when the contract was concluded. If the dispute settlement clause is not independent from the contract, the avoidance of the contract will make the court's jurisdiction groundless. Assume again that the parties have their dispute solved under the dispute settlement clause during their performance of the contract, but the contract was declared void and null later on. Then the validity of the settlement of the dispute between the parties will be challenged if the dispute settlement clause is to be affected by the avoidance.

Two points on this matter need to be further addressed. First, if there is a dispute settlement clause in the contract, the clause shall be deemed to have independently existed. Second, the dispute settlement clause may take the form of either a clause in the contract or a separate agreement. As a practical matter, the dispute settlement clause stated in a contract shall include all possible mechanisms, such as amicable negotiation, mediation, arbitration or litigation.

5.4. Restitution and Compensation

There is no doubt that when a contract is avoided, the existing contractual relationship between the parties is terminated. In the meantime, however, after the avoidance of a contract, a new debtor and creditor relationship between the parties may be established by the operation of law. A self-explanatory reason is that before the avoidance of the contract, some performance may have already been made or certain amount of money may have already been paid (e.g. deposit), and then when the contract is avoided, an restitution or compensation may become necessary in order to prevent unjust enrichment. In the United States, such new relationship may be termed as "quasi-contract" under which restitution would be sought for money paid, service provided, or

[76] See Yang Lixin, *supra* note 55 at p. 104.

damages caused. In China, there is no "quasi-contract" concept, but the remedy for restitution or compensation is available.

Pursuant to the Contract Law, there are three remedies in terms of restitution or compensation. The first one is return of property. Under Article 58 of the Contract Law, after avoidance or rescission of the contract, the property acquired as a result of the contract shall be returned. The very purpose of the return of property is to restore the parties to the position as if there had been no contract.[77] In light of restitution, the property includes both in kind and money received. And the return of property could be either unilateral or bilateral depending on whether only one party has received property from the other or the parties have received property from each other. If the parties acquired in kind or cash from each other, the return of property will be bilateral and the money mutually paid will be set off.

The second remedy is monetary compensation. Article 58 of the Contract Law further provides that where the property cannot be returned or the return is unnecessary in the case of contract avoidance, a monetary compensation shall be made. The specific money amount for the compensation shall be dependent on the value of the property. The property that cannot be returned is generally interpreted to refer to the property for which a return is either legally or factually impossible, which includes the property that is lost and not fungible (irreplaceable), or the property that is seriously damaged and irreparable, or the property in the form of know-how or services. Unnecessary return is a bit complicated and all depends on whether, from the viewpoint of the parties, it will make any sense to return the property.[78]

The third remedy is damage. The damage applies when a party is at fault, which causes the other party to suffer losses. According to Article 58 of the Contract Law, after the avoidance of a contract, the party at fault shall compensate the other party for losses as a result thereof. If both parties are at fault, each party shall be respectively liable. What Article 58 actually tells is that to recover for damage two things must be proved: actual losses and existence of fault. The losses may take place during the conclusion of the contract or occur in the performance of the contract.

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[77] There is a disagreement among Chinese scholars on the nature of the return of property. Some argue that the return of property is based on the right of ownership because when a contract is avoided, the party who acquired the property will lose his ownership of the property and the ownership will be restored back to the original party. Under this theory, the return of property is return of ownership. Others disagree by contending that the return of property is based on the doctrine of unjust enrichment because it is a remedy on the ground of contract not property.

[78] See Li Guoguang, *supra* note 28 at pp. 245–246.

With regard to the parties to the contract, the remedies as a result of avoidance of a contract are not available in the case where the contract is void for malicious collusion to damage the interests of the State, a collective or a third party. In this situation, the property acquired shall be subject to the State confiscation. It is provided in Article 59 of the Contract Law that if the parties have maliciously conducted collusion to damage the interests of the State, a collective or a third party, the property so obtained shall be turned over to the State or returned to the collective or the third party. Obviously, it is to impose sanction on the wrong doers for the public policy concern.

6. Conditions Affecting the Validity of Contacts

When making a contract, the parties may agree to attach certain conditions on which the contract would be affected. Distinctively, the conditions for a contract in China are tied to effectiveness of the contract, which means that upon the occurrence or non-occurrence of the agreed conditions, the contract may take effect or become null and void. In this sense, a condition may be deemed as a limitation on the validity of the contract. To compare, conditions in American contract law are related to performance. Section 224 of the Restatement of Contracts (2nd) defines the condition as "an event, not certain to occur, which must occur, unless its non-occurrence is excused, before performance under a contract becomes due."[79] In China, however, conditions are associated with the effect of contract.

In the Chinese contract literature, a condition is generally defined as the uncertain future fact. A popular view is that a condition as used in contract is an auxiliary clause that is based on the occurrence of uncertain fact to determine the effectiveness of the contract. Thus, for a fact to become a condition, it is required that (a) at the time of contract the occurrence of the fact was uncertain (the past or existing fact is not a condition), (b) the occurrence of the fact is possible (the fact that will never occur or will definitely occur is not a condition), (c) it is unpredictable or uncertain as to when the fact will occur, (d) the fact is chosen by the parties, not the one provided by the law, and (e) the fact is legal.[80] The Supreme People's Court is also of opinion that a conditional civil act shall be deemed invalid if the condition is in violation of the law or impossible to happen.[81]

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[79] See the Second Restatement of Contracts, § 224.

[80] See Jiang Ping, *supra* note 55 at p. 36.

[81] See Supreme People's Court, *Opinions*, *supra* note 9, art. 75.

In addition, the condition in China is divided into effecting (or entry-into-force) condition and dissolving (or come-to-a-stop) condition.[82] The effecting condition is the one without which a contract would not take effect. The dissolving condition is just the opposite, and it refers to the one with which the contract would be dissolved. Under Article 45 of the Contract Law, the parties may agree on the conditions upon which the effectiveness of contract is contingent. The contract with an effecting condition shall take effect when such condition is satisfied. The contract that has a dissolving condition shall become null and void at the time such condition takes place.

With an effecting condition, the validity of a contract is contingent upon the occurrence of the condition. If the condition occurs, the contract will become effective, or otherwise the contract will remain ineffective. Because the effecting condition affects the effectiveness of the contract, it is also called "suspensive condition" or "postponement condition." The very basic idea, as the term itself suggests, is that if an effecting condition is attached to the contract, rights and obligations of the parties are ascertained at the time of contract, but the effectiveness of the contract is suspended (or postponed) until the occurrence of the condition. For example, A asked B to contribute RMB 10 Yuan to buy lottery tickets, and A told B, to which B agreed, that if any of the tickets wins the lottery, they will equally share the prize. Thus there was a contract between A and B to share the money won from the lottery, and the effecting condition is the "winning ticket." Hence, the contract will not take effect until they have the winning ticket.

A dissolving condition applies to the contract that has taken effect, but when the condition occurs the contract will cease to be effective. Because the dissolving condition determines continuity of the validity of contract, it also named as extinguishing condition, which means that the validity of the contract will be extinguished upon the occurrence of the condition. For example, assume that A agreed to rent his apartment located in the City S to B, and in the lease agreement, B agreed that if C returns to City S, the lease will be terminated. In this situation, the C's return to City S is the condition upon which the lease agreement between A and B is to be dissolved. Therefore, whenever C returns to City S, the contractual relationship between A and B will be extinguished because the agreed condition is satisfied.

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[82] In American contract law, the condition is classified as condition precedent, concurrent condition and condition subsequent. As Professor Rosett pointed out, condition precedent is en event that must exist or occur before a duty of immediate performance of promise arises. Where the occurrence of an event extinguishes an existent immediate duty to perform, the condition is said to be subsequent. A condition is concurrent if a party's duty to perform is conditional upon a simultaneous tender of performance by the other. See Rosett & Bussel, *Contract Law and Its Application* (6th ed.), 693–695 (Foundation Press, 1999).

As far as the form of the agreed condition is concerned, the Contract Law contains no indication about whether the condition must be made expressly or it could be implied. But it might be concluded that if there is a condition, the condition shall be expressed in the agreement because the language of Article 45 of the Contract Law seems to only recognize the condition that agreed by the parties. There is a policy issue in Article 45 as well, which is that the parties are prohibited from manipulating the condition. Under Article 45, if a party, for its own benefit, prevented the condition from occurring without justification, the condition shall be deemed to have occurred, and conversely, if a party unjustly made the condition to occur, the condition shall be regarded as having not occurred.[83]

In addition to the conditions, the Contract Law also allows the parties to subject the validity of the contract to a time period. A contract to which a time limit is attached means that the validity of the contract is to be affected by the expiration of the time period. Like the condition, the time period is also split into effecting time and dissolving time. Under Article 46 of the Contract Law, the parties may agree on a time period to be attached to the effectiveness of the contract. A contract subject to effecting time period shall be effective when the period expires, and a contract subject to dissolving time limit will become ineffective when the period comes to an end.

The commonality between the time period and the condition is that both are the facts affecting the validity of the contract, but they are different in that the condition is an uncertain fact at the time of contract, while the time period is a certain fact at the time of contract. The certainty of the time period means that the parties knew when concluding the contract that the time would come at the particular point. Assume that A enters into a contract with B to deliver certain goods from A to B. In the contract the parties agree that the contract will ends on the day of the opening ceremony of the 2008 Olympic Game in Beijing. The contract then has a time period because the "2008 Olympic Game" is the event that has a fixed day to open and therefore is certain. If, however, it is agreed that the contract will end on A's birthday next year, and then the "A's birthday next year" is not a time period but a condition because A may die anytime before his next birthday, and thus the upcoming "birthday" is uncertain though the actual date of A's birthday is known.

Note also that the time period attached to a contract is different from time period for performance. As discussed above, the time period attached to a contract concerns the validity of the contract because the contract may become effective or stop being effective upon the expiration of the period. The time period provided for performance, however, deals with the tender of the duty to each other between the contracting parties after the contract takes effect.

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[83] See the Contract Law, art. 45.

Chapter VII
Performance of Contracts

Contract performance concerns the accomplishment of legal duties or obligations that become due as agreed upon by the parties under the contract. Termed as the conduct of fulfilling contract obligations, performance in China is deemed as the core of contract law because it involves both the completion of the promised obligations and realization of the expected rights. Under the Contract Law, a contract, once it becomes effective, must be properly and completely performed.

At the threshold of discussion, three points need to be stressed. First, as previously discussed, the law in China has a marked tradition of civil law, where statutes play a dominant role. Partly influenced by this tradition, legal principles derived from the statutes are always the center of discussion. It is a very common phenomenon in China that the legal principles are the major content of almost every law textbook. Therefore, this chapter will begin with a review of the principles that govern the performance of contract. Second, the contract performance, as provided in the Contract Law, involves many rules that are typically civil-law-based. It is then conceivable to see the wide difference between civil law and common law in the area of the contract performance. Third, the contract performance, though in principle covered in the General Provisions of the Contract Law, is in great detail prescribed in the Special Provisions of the Contract Law with respect to specific contracts. Our focus, however, is still on the general provisions.

1. Complete and Adequate Performance

As in civil law, the Contract Law has a clear emphasis on the principle of compete and adequate performance because performance is what the contract is all about in terms of realizing the goal for which the parties have bargained. In Article 60 of the Contract Law, it is required that the parties perform their obligations completely and thoroughly according to the terms of the contract.[1]

The complete and adequate performance on its face imposes an obligation on the parties to perform what they promised or agreed in the contract to the extent that all legal duties are completely fulfilled and all legal rights are satisfied. In this regard, a performance is complete and adequate when the parties perform the contract obligations exactly under the terms and conditions of the contract. Therefore, any noncompliance with the required terms and conditions of the contract will render the performance incomplete and inadequate. But, scholars in China, in addition, have suggested that complete and adequate performance shall include proper performance, referring to the way in which the contract is performed. A performance is proper if the contract is performed by correct party at the agreed time and place, with conforming goods or services.[2]

Because of the requirement for the complete and adequate performance, the doctrine of the substantial performance does not apply in China under the Contract Law. Thus, the damage for breach of contract will be imposed if performance is found defective. There are two articles in the Contract Law that directly deal with defective performance. One is Article 71 that is related to the advance performance, and the other one is Article 72 that concerns partial performance. But in both cases, only the contracts with a fixed or agreed time period for performance are relevant.

An advance performance is the performance that is made ahead of the agreed time to perform. The advance performance may occur either at the request of the obligee or at the initiative of obligor. What matters here is the performance that is advanced at the initiative of obligor. Under Article 71 of the Contract Law, the obligee may reject an advance performance of the contract by the obligor. Article 71, however, does not permit the obligee to reject the advance performance that causes no damages to the interests of the obligee. This exception is intended to help facilitate transactions and maintain the business relationship between the parties. But if the advance performance

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[1] See the Contract Law, art. 60.

[2] To certain extent, the complete and adequate performance has something in common with the perfect tender rule incorporated in § 2-601 of the UCC, which requires the full tender of perfectly conforming goods.

causes additional costs to the obligee (e.g. warehouse fees), the obligor shall bear the costs.[3]

Partial performance is deemed as a defective performance because it violates the principle of the complete and adequate performance. Article 72 of the Contract Law makes it clear that the obligee may reject the partial performance of the contract by the obligor. Once again, there is an exception, that is, the partial performance may not be rejected if it does not damage the interest of the obligee.[4] Mostly, the partial performance is permissible when the contract itself is divisible and could be performed separately. Another case in which the partial performance is acceptable is that the parties agreed to have the contract performed in parts. For example, if the parties have an agreement that the delivery may be made in batches, each batch then will be regarded as partial performance, which does not constitute a breach of the contract. However, the obligor will be responsible for any additional costs that may incur to obligee during the course of the partial performance.

2. Good Faith Performance

Closely related to the complete and adequate performance is the principle of good faith performance. As we have noted, good faith is a general principle in the Contract Law, which is based on moral values and standards. Applied to contract performance, good faith means to perform the contract according to the nature, purpose of the contract as well as the transaction usages. Since the complete and adequate performance is the primary requirement for performing the contractual obligations, the good faith performance is used as secondary and supplementary means to ensure that the performance is to be made completely and adequately. The general notion is that the good faith principle, though appearing a bit abstract, has irreplaceable function in helping determine the completion and adequacy of contract performance, particularly in cases where the parties' agreement concerning performance is incomplete or vague.

Following this notion, Article 60 of the Contract Law in addition provides that the parties shall abide by the principle of good faith and shall perform the duties such as notice, assistance and confidentiality on the basis of the nature and purpose of the contract or transactions practices.[5] To be more explicit, the

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[3] See the Contract Law, art. 71.

[4] See *id*., art. 72.

[5] See *id*., art. 60.

good faith performance principle under Article 60 of the Contract Law mainly involves the performance of two basic duties that are commonly called in China as the "attached duty" and "other related duty".[6]

The attached duty is the duty subordinating to the main duties of the contract, and it entirely depends on the existence of the contractual relationship between the parties. The underlying theory is that since contacts are cooperative behavior through which the parties agree to work together,[7] it is essential that the parties cooperate with each other in such a way that may not be explicitly provided in the contract, but would be required under the good faith principle. Thus, the attached duty is the duty necessitated by the contract and is derived largely from the reasonable business standards and expectations. On this ground, to perform the attached duty is not to increase the burden of either party, but rather it is the natural duty imbedded in the performance of contracts.

In accordance with Article 60 of the Contact Law, the attached duty includes the duty to give notice, duty to assist and duty to maintain confidentiality. The duty of notice necessarily arises when a contractual relationship is established between the parties. It is required under the good faith principle that the parties during the contract performance shall faithfully inform each other of all major events or changes that may affect the performance of the contract in order to facilitate the completion of the performance. For example, if a party is unable to perform or could not perform the contract under the required terms or conditions due to an unexpected reason, such as *force majeure*, he shall notify the other party in a timely manner so that the parties can take steps to deal with the situation.[8] Under Article 70 of the Contract Law, if the obligee does not notify the obligor of its separation, merger or change of its domicile, which makes it difficult for the obligor to perform the obligations, the obligor may suspend the performance or submit

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[6] To compare, Restatement of Contracts, section 205 provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Similarly, UCC section 1-203 provides: "Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement".

[7] See Rosett & Bussel, *Contract Law and Its Application* (6th ed), 697 (Foundation Press, 1999).

[8] Some scholars in China suggest that the duty of notice under the good faith performance principle shall include notice of (a) means to use; (b) defects; (c) report; (d) danger; (e) business condition, (f) delay; (g) assignment/delegation; (h) event affecting performance; and (i) inability to pay. Many disagree because they think that several duties listed above are not the duties attached to the contract, rather they are the duties provided by the contract. See Cui Yunling, *General View on Contract Law*, 158 (China University of People's Public Security Press, 2003).

the subject matter of the obligation (or the subject matter of the contract) to relative authority.[9]

The duty to assist is an inherent obligation of the parties to a contract. Because the contract is the product of cooperation of the parties, good faith principle requires the parties to be cooperative with each other. The cooperation under the good faith principle implies that the parties are obligated to assist each other in performing the contract and to facilitate the completion of the performance. As advocated by Chinese contract scholars, the duty to assist may include several aspects. In one aspect, a party, when performing his own contract obligations, shall try to pave the way for the other party to perform and shall also be prepared to accept the other party's performance. In other aspect, if a party is facing certain difficulty in performing the contract because of an objective reason, the other party shall give reasonable consideration to this situation and try to help overcome the difficulty, and if necessary, shall negotiate the options with the party facing difficulty in the performance. Moreover, in case of a party's breach, the other party shall take all measures that are needed to mitigate the damages. A few scholars also believe that under the duty to assist, the parties, when dealing with contractual disputes between them, shall treat each other in a responsible way.[10]

The Contract Law does not specify what legal consequences there will be if a party fails to carry out the duty to assist. In practice however, the failure may result in certain remedies against the non-assisting party depending on the distinction of the case.[11] For example, under Article 101 of the Contract Law, if the obligee refuses to accept the subject matter of the contract without justified

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[9] The submission of the subject matter of the contract with relevant authority is a statutory relief available to the obligor. As will be discussed later in other chapter of this book, this relief is normally used when the obligor could not make delivery of the contracted item either because the obligee's whereabouts is unknown or the delivery was refused by the obligee without legitimate reason.

[10] See Cui Yunling, *supra* note 4 at pp. 158–159; See also Wang Liming & Cui Jianyuan, *A new Commentary on Contract Law – General Provisions* (revised edition), 320 (China University of Political Science and Law Press, 2000).

[11] One Chinese scholar summarizes such consequences to include 6 categories: (a) transfer of risk – failure to pick up the goods timely; (b) stop accruing interest – failure to accept payment as agreed; (c) extinguishment of guarantee – refusal to accept timely payment; (d) payment for damage or expenses – failure to timely use the materials provided by the other party; (e) extermination of obligation – failure to accept timely performance; and (f) modification or rescission of the contract – failure to assist, which result in impossibility of performance by the other. See Dong Ling, *Performance, Modification, Assignment and Termination of Contracts*, 20–21 (China Legal System Publishing House, 1999).

reason, the obligor may submit the subject matter to relevant authority, and then the obligor's obligation is discharged.[12] Another example is Article 259 of the Contract Law that involves contract for work. According to Article 259, if the contracted work needs an assistance of the ordering party, the ordering party shall have the obligation to provide the assistance. Where the ordering party fails to fulfill his obligation of assistance so that the contracted work could not be finished, the contractor may urge the ordering party to perform the obligation to assist and may extend the term of performance if necessary. The contractor may also rescind the contract if the ordering party does not perform his obligation to assist within the time limit.[13]

Duty to maintain confidentiality is another important element in performance. Actually it is the extension of the duty that arose at the time of the contract negotiation. When making a contract, the parties have the opportunity to know each other's business secrets, and it is critical that the parties maintain confidential each other's business information obtained during the process of contract making as well as the performance. Confidentiality is also required by the mutual trust on which the parties made the contract between them. A breach of the duty to maintain confidentiality would indicate bad faith for which the contractual liability, and in many cases tort liability as well, will be imposed.

The other related duty is a "catchall" provision. It deals with all other obligations that are necessary for the performance of contract but may not be clearly stated or provided by the parties. As noted, good faith performance in China is regarded as complementary, and thus the other related duty refers to the one that is not specified in the contract or the specification of such duty is vague, but the imposition of which upon the parties is needed for the complete and adequate performance of the contract. For example, after conclusion of the contract, each party has the duty to prepare well for the performance. Although such a duty may not be expressly stated in the contract, it is naturally induced that each party is under obligation to make good preparation for the performance. Failure to prepare may constitute the bad faith, particularly when the failure is made intentionally.

One important point to note is that neither the contract Law nor the 1986 Civil Code distinguishes regular contracting parties and merchants. In a country like US, the contract laws impose higher standards on the merchants than on the non-merchants. In China, however, both merchants and non-merchants are treated the same under the Contract Law with regard to the contract. For instance, in the US, the key element of good faith in the contract

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[12] See the Contract Law, art. 101.

[13] See *id*., art. 259.

performance is honesty. But as applied to merchants, the UCC requires that in addition to honesty, the merchants shall also observe "reasonable commercial standards of fair dealing in the trade".[14] In China, the Contract Law imposes the unified good faith standards on all contracting parties regardless of their business status.

3. Determination of Obligations to Be Performed

As discussed in Chapter VI, the Contract Law contains the provisions that are aimed at helping fill the gap between what the parties have agreed in the contract and what would be needed in the contract. The gap-filling provisions become relevant when certain terms of the contract are either not explicitly provided or unclear, and such provisions, though relevant in the interpretation of the contract, are primarily involved in the performance of the contract. It, however, should be noted that the gap-filling provisions are applicable only to those terms that do not affect the completion of the contract but may cause difficulty in performing the contract. The purpose is to ascertain that a contract, once lawfully established, is to be performed if there is no statutory reason that would serve as an excuse for the non-performance.

The gap-filling provisions concerning the performance of the contract are regarded as necessary in China because the Contract Law requires that the contract be performed completely and adequately. The reality is that in many cases, certain contractual obligations need to be further determined at the time of performance because at the time the contract was concluded the parties may overlooked some items or failed to predict what would happy when performance comes due. Since the existence of such uncertainty would make it difficult to perform the contract, there is a necessity to make up by filling the gap in order to make the adequate completion of the performance possible.

The basic gap-filling provisions in the Contract Law are Articles 61 and 62, which set forth two basic approaches for the determination of the obligations to be performed: consensual approach and statutory approach.[15] Under Article 61, the parties may by agreement supplement to the contract such terms as quality, price or remuneration, or the place of performance if they were not clearly

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[14] See U.C.C. § § 2-103(1)(b) and 2A-103 (3).

[15] In addition Articles 61 and 62, there are more than 20 articles in the Contract Law that are directly affected by the application of Article 61 and 62 in determining the obligations for purposes of performance. According to one scholar's survey, the articles related to Articles 61 and 62 include: Articles 111, 139, 154, 156, 159, 160, 161, 205, 206, 226, 232, 250, 263, 310, 312, 338, 341, 354, 366, 379, 418, and 426. See Dong Ling, *supra* note 11 at p. 26.

specified or provided at the time of contract. In addition, the trade practice may also be used to help determine the above-mentioned terms.[16]

As discussed in Chapter V, Article 62 provides a laundry list for determining the terms concerning the quality, price and remuneration, place of performance, time period of performance, method of performance as well as the expenses incurred in the performance in case the parties could not reach an agreement pursuant to Article 61. Unlike Article 61 that addresses the agreement of the parties, Article 62 is required to apply in absence of the parties' agreement, and in this sense the provisions in Article 62 are also called statutory gap-fillers.

It is helpful to observe some of the statutory gap-fillers listed in Article 62. The first one is quality provision. According to Article 62, when the quality of the contracted items is at issue, the State or industry quality standard shall be used first. Only if there is no State or industrial quality standard available, may the common standard or the specific standard conforming the purpose of the contract be employed.[17] The common standard is referred to the one that the product or goods in question shall generally meet. If, however, the common standard is not available, the courts may look at the medium quality level of the same or similar products or goods that possess the general merchantability to determine an applicable standard.[18]

The second statutory gap-filler that needs to be further illustrated is the place of performance. It is particularly addressed in Article 62 because the place of performance may affect the determination of the parties' rights and obligations. From the conflict of laws perspective, the place of performance may serve as a "connecting point" under which a court jurisdiction would be established or the applicable law would be identified with regard to the contract performance. Pursuant to Article 62, the place of performance is to be determined in three different ways: (a) the place of the party who receives monetary payment if the performance involves the payment in currency; (b) the place where the property is located if the performance is about the delivery of real estate; or (c) the place of the performing party if the performance concerns all other items.[19]

The third statutory gap-filler that is important and unique in China is the price. There are two prices that may be related to a particular contract performance: market price and State price. As previously noted, the State price in China is divided into the State stipulated (or mandatory) price and the State

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[16] See the Contract Law, art. 61.

[17] See *id*., art. 62.

[18] See Li Guoguang, *Explanation and Application of the Contract Law*, 274–275 (Xinghua Press) (1999).

[19] See the Contract Law, art. 62.

guidance price. If a contract is covered by the State price, such a price must be accepted. As we have explained, the difference between the Sate stipulated price and State guided price is that in the latter case the parties would have certain room to determine the price they wish around the range of the State guidance price. If a contract is not required to apply the State price, the applicable price shall be determined by the market price of the place of performance at the time of contract.

In addition to Article 62, the Contract Law has a special provision that applies to the case where there is a change of the State price. In accordance with Article 63, for a contract that is required to apply the State stipulated price or the State guidance price, where the State price is adjusted within the delivery period of the contracted items, the price at the time of delivery shall apply. If the delivery is overdue and the price goes up at the time of delivery, the price shall remain unchanged. And if the price goes down, the new price shall apply. In the event of delay in taking the delivery of the contracted items or late payment, if the price rises, the new price shall apply; but if the price drops, the original price stays.[20]

4. Right of Defense to Non-Performance

The right of defense to non-performance of contract is a civil law concept that is designed to protect obligor from being harmed by the abuse of right of the obligee. It applies only in a bilateral contract where the parties are mutually obligor and obligee to each other. By definition, the right of defense is the right to defend against the claim of the other party or to deny the right asserted by the other party. In the sense in which the obligor may refuse to honor the obligee's request, the right of defense is also called the right of opposition.

Keep in mind that the right of defense to non-performance is not a denial of contractual obligation or a discharge of contractual duties that are being excused; rather it provides the obligor with the legal ground on which the obligor may refuse the obligee's request for performance. The underlying notion is that in a bilateral contract, the rights and obligations between the parties are reciprocally connected and mutually dependent. One party's performance is a prerequisite of the other party's performance, and each party, when enjoying the rights under the contract, correspondingly bears contractual obligations. Thus, in order to realize the contractual rights, the parties must each perform their respective obligations. Without one party's performance, the other party's performance would not occur.

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[20] See *id*., art. 63.

Therefore, the right of defense to non-performance is a self-protection right that is created by the law in order to help maintain the balance of interests of the parties in the course of contract performance. Based on such right, a suspension of performance of contract by one party, which takes place in the situation where the party wants to be sure that the other party will properly perform, is not a break of contract. In this regard, many Chinese contract law scholars regard the right of defense to non-performance as a guarantee of contractual rights.[21]

The right of defense to non-performance did not appear in Chinese contract legislation until the adoption of the Contract Law. In the past, a concept of "mutual breach" was widely used in the judicial practice because at that time it was overly emphasized that a contract involves mutual obligations between the parties and whoever did not perform the contract would be held liable regardless of the reason for the non-performance. The enactment of the Contract Law makes it possible for the parties to protect their contract interests through exercise of the right of defense without litigation.

As provided in the Contract Law, the right of defense to non-performance consists of fulfillment plea and unrest defense. Once again, one may barely find any equivalent concepts in this regard in common law contract theories or practice because those are the concepts typically in the civil law system.

4.1. Fulfillment Plea

Fulfillment plea is the right granted to a party in a bilateral contract to refuse to perform or to reject the request of the other party for performance before the other party performs or properly performs the contract. Under the fulfillment plea, since the parties to a contract are mutual responsible to each other and each bears a duty of performing contractual obligations to the other, any non-performance or non-conforming performance of one party will constitute a ground for the other party to refuse to perform. To illustrate, in the contract in which the parties agreed to the time at which one party makes the delivery and the other party makes payment, if at the provided time, the delivering party failed to deliver, the other party then has the right to refuse the other party's request for the payment.[22] A practical importance of the "fulfillment

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[21] See Dong Ling, *supra* note 11 at p. 62.

[22] concept of fulfillment plea looks similar to the doctrine of concurrent condition in common law system. In the US for example, the concurrent condition is defined to exist where the parties are to exchange performance at the same time. But difference is that the fulfillment plea is to give a party the right to refuse to perform, for which no breach of contract will be held, while under the concurrent condition unless tender is excused, a party must perform or tender performance before the party has a claim. See Calamari & Perillo, *The Law of Contracts (4th ed)*, 399 (West Group 1998).

plea" is that it helps a court or arbitration body to draw a line between breach and non-breach of the contract, especially when a "contributory breach" defense is asserted because the non-performance by a party exercising the "fulfillment plea" is not a breach of contract.

The Contract Law divides the fulfillment plea into two categories: "simultaneous fulfillment plea" and "orderly fulfillment plea". The simultaneous fulfillment plea occurs where the contractual obligations of the parties are mutually implicative. Under Article 66 of the Contract Law, if the parties have obligations toward each other and there is no order of priority in performance, the parties shall perform the obligations simultaneously.[23] A contracting party has the right to reject the other party's performance request before the other party performs, and also to reject the other party's corresponding performance request if the other party's performance does not meet the terms or conditions of the contract.[24] The Contract Law does not specify the contracts in which the rule of simultaneous fulfillment plea may apply. But as interpreted by scholars, the application of simultaneous fulfillment plea mostly involves the contracts for sales and leases.[25]

It can be seen from Article 66 that to make a simultaneous fulfillment plea, four elements are required. The first element is mutual obligation. In order to qualify for a simultaneous fulfillment plea, the parties must be mutually obligated to each other in performing the contract. Because of the mutual obligation requirement, the simultaneous fulfillment plea only applies to a bilateral contract. The second element is performance without an order (which means that there is no requirement as to who performs first). In a contract where the performance is to be rendered under no particular order or the order of the performance could not be determined by law or trade practice or business dealings, the performance is deemed simultaneous. The third element is the performance that is due. To assert the simultaneous fulfillment plea, the performance must

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[23] See the Contract Law, art. 66.

[24] The Principles of International Commercial Contracts of UNIDROIT contains a similar provision. Article 7.1.3 (1) of the Principles provides: "Where the parties are to perform simultaneously, either party may withhold performance until the other arty tender its performance."

[25] For example, Article 221 of the Contract Law provides: "The lessee may request the lessor to maintain and repair the leased property within a reasonable period of time when the leased property needs maintenance and repair. Where the lessor fails to perform the obligation of maintaining and repairing the leased property, the lessee may maintain it by itself, and the expenses for the maintenance shall be borne by the lessor. If the maintenance affects the use of the leased property, the rent shall be reduced or the lease term shall be extended correspondingly". This provision is said to give lessee right to exercise the simultaneous fulfillment plea when the lessor fails to perform its duty to maintain the leased property. See Wang Liming, *Study on Contract Law (Vol. II)*, 83 (People's University Press, 2003).

become due. If the time for performance has not arrived, there is no obligation to perform. The forth element is non-performance or non-conforming performance by a party. The simultaneous fulfillment plea takes place where a party does not perform what he is supposed to fulfill. Note that the non-performance or non-conforming performance is referred to the performance that is possible, excluding the one that might be excused under the law, e.g. on the ground of *force majeure* or frustration of purpose of the contract.[26]

Orderly fulfillment plea is the defense against a party who under the contract should performance first but fails to do so. In accordance with Article 67, where the parties have mutual obligations and the performance of the obligations takes an order of priority, the party who should perform subsequently has the right to reject other party's performance request if the other party who should perform first has yet not made the performance.[27] In addition, if the performance by the party who has the duty to perform first does not meet the contract requirements, the other party has the right to reject the corresponding performance request.

The orderly fulfillment plea is intended to protect the interest of the party whose performance is subsequent to the performance of the other, and to urge the party who is supposed to perform first to fulfill his obligations. The orderly fulfillment plea applies where the first performing party did no perform or the performance was defective. It should be noted that the orderly fulfillment plea, like the simultaneous fulfillment plea, is to give a party the right to withhold the performance until the other party performs.[28] Therefore, when the prior performing party performed after the assertion of the orderly fulfillment plea, the asserting party must then perform. In case where the orderly fulfillment plea is made, the prior performing party may be held liable for any delay in its performance, but no liability would be imposed on the other party for not being able to timely perform due to the prior performing party's delay.

There is an on-going debate among Chinese contract scholars on the term of orderly fulfillment plea. Although it is agreed that the orderly performance plea involves consecutive performance, no consensus has been reached as to

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[26] Some argue that the possible performance of the party should be the fifth element needed to make a simultaneous fulfillment plea. They believe that if the performance of a party becomes impossible, there is no ground for the simultaneous fulfillment plea, and the damaging party may have to seek for other relief. See Cui Yunling, *supra* note 4 at pp. 171–172.

[27] See the Contract Law, art. 67.

[28] The term of fulfillment plea is not used in the Principles of International Commercial Contracts of UNIDROIT, but a term of withholding performance is used instead. Wither regard to orderly performance, Article 7.1.3.(2) provides: "Where the parties are to perform consecutively, the party that is to perform later may withhold its performance until the fist party has performed."

how the orderly performance plea should be termed. Some argue that the orderly performance plea should be named as the defense right for prior performance because it is the right against the party who should perform first.[29] Others disagree. They suggest that the orderly fulfillment plea should be called the defense right for subsequent performance since the right of defense in this case belongs to the subsequently performing party.[30] However it is named, in order not to be confused, one should bear in mind that orderly fulfillment plea in China generally mean the Article 67 right of defense.[31]

4.2. Unrest Defense

Originated in civil law system, the unrest defense means that under certain circumstances, the party who should perform first the contract obligations (commonly called in China the prior performing party) may suspend its performance until the other party's performance is ascertained. The unrest defense provides the prior performing party with right to suspend its performance if it believes with certainty that the other party will not or will not be able to perform at the time of performance. As a result of exercise of the unrest defense, the performance of the prior performing party is suspended unless and until the other party's performance is guaranteed or is proven to be certain.[32]

Article 68 of the Contract Law provides the unrest defense right under which the prior performing party may suspend its performance if it has conclusive evidence of any of the followings: (1) the other party's business conditions are seriously deteriorating; (2) the other party moves away its property or takes out its capital to evade debts; (3) the other party loses its business credibility; or (4) other circumstances showing that the other party loses or is likely to lose its capacity of performance.[33] Clearly the unrest defense right is a legal device to protect the interest of the prior performing party. It defers from the orderly fulfillment plea in that the orderly fulfillment plea is concerned about the protection of the interest of the subsequent performing party.

Like the fulfillment plea, the unrest defense is available only in bilateral contracts. There are two factors that are regarded essential to assert the unrest

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[29] See Dong Ling, *supra* note 11 at pp. 75–77; See also Li Guoguang, *supra* note 18 at pp. 294–296.

[30] See Wang Liming, *supra* note 25 at pp. 100–104.

[31] Few scholars name the unrest defense as the right of prior performance defense. See Cui Yunling, *supra* note 8 at p. 172.

[32] Some scholars compare doctrine of the unrest defense to the concept of implied anticipatory repudiation as used in the United States and believe that these two are substantially the same. By implied anticipatory repudiation, it was referred to the "prospective inability" stated in UCC § 2-609. See Dong Ling, *supra* note 11 at p. 79.

[33] See the Contract Law, art. 68.

defense. First, the party who asserts the unrest defense must be obligated to perform first under the contract, and the other party will perform thereafter. The consecutive performances between the parties make it necessary to protect the interest of the party who performs first. Second, there should exist definite evidences that the other party's ability or capacity to perform has been impeded so seriously that the performance is unlikely to take place, and the impediment is caused by the statutory reasons as listed in Article 68. If, however, as Article 68 further provides, it turns out that the prior performing party asserts unrest defense to suspend its performance without conclusive evidence, the asserting party shall be liable for breach of contact.

There is a question about when the change of the situations that affect the subsequent performing party's ability to perform would count for making the unrest defense by the prior performing party. For example, under Article 68 of the Contract Law, the prior performing party may suspend its performance if the other party's business conditions are seriously deteriorating. Should the fact of deteriorating business situation of the other party occur before the conclusion of the contract or afterwards in order for the prior performing party to be able to assert unrest defense?

It is generally held that the unrest defense applies to the situation that has changed after the contract is formed. The reason is that if the prior performing party has the knowledge of the other party's deteriorating business situation at the time of contract, the doctrine of assumption of risk may prevent the prior performing party from asserting any defense. It is suggested that even if a party made a contract with the other party without the knowledge that that the other party's business situation had deteriorated before the contract was concluded, the party may seek for recession of the contract, but not the unrest defense.[34]

Another question is whether the unrest defense should be made before the performance of the contract is due or could be made after the prior performing party has started its performance. The Contract Law is not clear about it because Article 68 only provides that the prior performing party may suspend its performance if it has conclusive evidence that the other party is unlikely to perform. The general implication is that the unrest defense is available after conclusion of the contract and before performance of the contract since the unrest defense serves as a safeguard for the prior performing party against the possible harm caused by the other party's failure to perform.[35]

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[34] See Wang Liming, *supra* note 25 at p. 107.

[35] But, some argue that the unrest defense may also be asserted by the performing party after its performance began. In other words, the performing party will not be held liable for breach of contract if it suspends its on-going performance when it believes with evidence that the other party will not be able to perform. See Dong Ling, *supra* note 11 at pp. 87–88.

However, the exercise of the unrest defense is limited under Article 69 of the Contract Law. The limitation has two parts: (a) when suspending its performance, the prior performing party shall notify the other party of the suspension, and (b) if the other party provides an adequate guarantee, the prior performing party shall resume its performance.[36] Therefore, without notice, the prior performing party may not suspend its performance, and an unreasonable suspension of performance after an adequate guarantee is provided may make the prior performing party liable for breach of the contract.

In addition, Article 69 gives the prior performing party a relief of recession of the contract in the situation where the other party's ability to perform the contract is substantially impeded. According to Article 69, if the other party, within a reasonable period of time after the performance is suspended, is unable to reinstate its ability of performance and fails to provide an adequate guarantee, the party suspending the performance may rescind the contract.[37]

In order to avoid the rescission of the contract, the party against whom the unrest defense is asserted must meet two requirements: (a) to reinstate its ability to perform and (b) to provide adequate guarantee within a reasonable period of time. The "adequate guarantee" is understood to mean that the guarantee is sufficient enough to bear the liability for damages if the subsequent performing party fails to perform the contract. But the question is what time period would be considered reasonable. Due to the silence of the Contract Law, it is entirely up to the court or arbitration body to make a determination on a case-by-case basis.

5. Protective Measures for Performance

As emphasized in Chapter I of the book, a contract in China is deemed as a relationship of *obligatio* between the parties, under which they are both obligor and obligee to each other (with an exception to unilateral contracts). Therefore, once a contract is formed, such an *obligatio* relationship is created between the parties, and to realize the contractual interests of the obligee is to fully perform the contractual duties of the obligor. Generally, under the *obligatio* relationship, the obligor is obligated to perform the contact. Thus, in cases where the obligee's contractual interests are, or are likely to be, adversely affected, the assets of the obligor may be used to assure the realization of such interests. The "assurance" so provided is commonly called the protective measures for performance because it is used to protect against the

[36] See the Contract Law, art. 69.

[37] See *id*.

change of the obligor's assets that may necessarily affect the contractual interests of the obligee.

The Contract Law embraces two protective measures: the right of subrogation and the right of cancellation. Both rights are granted to obligee and are purposed to ensure that the obligee's interests under the contract will be realized. It is proper to say that the protective measures, as provided in the Contract Law, are the statutory relief for the obligee to prevent the obligor from inappropriately reducing the obligor's assets to impede the obligee's contract interests. Note that although both the right of subrogation and the right of cancellation belong to the obligee, the exercise of such rights may only be made by a court order. In other words, the obligee would need to bring an action in a court in order to take any of the protective measures.

5.1. Right of Subrogation

Subrogation means that in order for the contractual interests of the obligee not to be harmed, the obligee may in its own name exercise the creditor right of the obligor against a third party who is the debtor to the obligor. To illustrate, assume that A owes B, and C owes A, and if A fails to perform its obligation to pay B, B has the right to ask C to pay B as if C pays A. The theory is the external effect of the *obligatio*, which allows B's contractual right to be extended externally against C, the third party. As a general principle of contract, the obligee could only ask obligor to perform under the contract between them because the contract may not obligate a third party without the third party's express consent. However, if the obligor's conduct with a third party may adversely affect realization of the interests of the obligee, the obligee would under the law be able to take certain action against both A, the obligor and C, the third party for purposes of removing the harm.[38]

The right of subrogation is provided in Article 73 of the Contract Law. Under Article 73, if the obligor is indolent in exercising its due creditor right against his debtor(s), which damages the interests of the obligee, the obligee may request the people's court for subrogating the obligor's creditor right and exercising it in the obligee's own name, except that the creditor right exclusively belongs to the obligor personally. It is further provided that the subrogation shall be exercised within the scope of the creditor right of the obligee and the necessary expenses incurred to the obligee by exercising the subrogation right shall be borne by the obligor.[39] In application of Article 73, the

[38] See Jiang Ping et al, *A Detailed Explanation of the Contract Law of Law*, 61 (China University of Political Science and Law Press, 1999).

[39] See the Contract Law, art. 73.

Supreme People's Court has explicitly explained how an action for subrogation should be taken.

5.1.1. *Conditions for Subrogation Actions*

Shortly after the Contract Law was adopted in 1999, the Supreme People's Court issued the *Explanation to Several Questions concerning the Implementation and Application of the Contract Law of the People's Republic of China (I).* In its opinions, the Supreme Court sets forth the conditions that an action for subrogation shall meet. In essence, the subrogation is a legal right of the obligee to protect itself from being damaged by the obligor's inactivity in exercising the obligor's own creditor right that has become due. Since the exercise of the subrogation would involve a third party, it is important that there is a valid ground for subrogating. According to the Supreme People's Court, to seek a subrogation action in the court, there are four conditions that must be met. The four conditions are: (a) the creditor right of the obligee against obligor is legal, (b) the obligor is indolent in exercising its creditor right, which causes damage to the obligee, (c) the creditor right of the obligor in question is due, and (d) the creditor right of the obligor is not a personal right of the obligor.[40]

The legality of the creditor right of the obligee means that there is a valid contract between the obligor and obligee, on which the creditor right of the obligee is based. If no contract as such exists or if the contract is void or rescinded, there would be no ground for the subrogation. Some, however, argue that in addition to the legality, the creditor right of the obligee against obligor should be certain. The certainty is deemed to be satisfied where either the obligor admits the obligee's creditor right, or such right is ascertained by the court or arbitration body.[41]

The indolence concerns the creditor right of obligor that is due and should be exercised. But this matter is being complicated by the scholars' arguments on what would constitute the indolence. One opinion is that the indolence refers to the failure to claim the right or the delay in making the claim.[42] The other opinion describes the indolence as the situation where the obligor should, and is able to, claim its creditor right through the means of litigation or arbitration,

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[40] See the Supreme People's Court, *Explanation to Several Questions concerning the Implementation and Application of the Contract Law of the People's Republic of China (I)*, art. 11, (1999).

[41] See Wang Liming, *supra* note 25 at pp. 134–135.

[42] See Wang Liming, *The Scholarly Suggestions and the Legislative Reasons for the Draft Civil Code of China*, 112 (Law Press, 2005). Here the draft Civil Code refers to the proposed comprehensive civil code that is in the process of drafting.

but fails to do so.[43] The major difference between the two opinions is whether the resort to litigation or arbitration should be the element for determining the indolence. Under the Supreme People's Court's Explanation, however, the subrogation should be made only if the obligor fails to make the claim of its creditor right that the obligor may claim through either litigation or arbitration.

The personal nature of the creditor right of the obligor implies the right that exclusively belongs to the obligor and may not be subrogated. In the opinion of the Supreme People's Court, the right that is deemed as personal includes the right for payment arising from alimony, child support, maintenance (support of parents and grandparents), as well as inheritance, and the right of the claim related to salary, retirement fund, pension fund, survivor's pension, relocation settlement fees,[44] life insurance and damages for personal injury.

Under Article 73 of the Contract Law, the personal right of the obligor shall not be subrogated. It is also important to point out that subrogation becomes necessary only when the available assets of the obligor are not sufficient to satisfy the creditor right of the obligee. If the available assets are sufficient, the obligee may simply seek to enforce the contract and there is no need to look for the creditor's right of the obligor against a third party.

One point that deserves further discussions is the determination of damages that incurred to the obligee for purposes of subrogation. The question that is necessarily encountered is how the damages should be defined. One argument is that in the context of subrogation, the damages should be the actual damages that are caused to the obligee by the indolence of the obligor in exercising the obligor's credit right against the third party. The actual damages doctrine is rested on the notion that because the obligor did not exercise its creditor right, and as a result, obligor's assets that were supposed to increase did not increase, which made it impossible to fully realize the obligee's interests, and therefore the obligee has the right to subrogate.

Another argument asserts that the damages as such mean the "likely danger" to affect the realization of the obligee's creditor right, and the danger is caused by the obligor's delay in performing its contract obligations and indolence in claiming the obligor's creditor right against a third party. Under this

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[43] The reason supporting this opinion is that to require the claim of the creditor right to be made by the means of litigation or arbitration will objectively help determine whether the obligor has been indolent in making the claim timely because the initiation of the litigation or arbitration will serve as an objective standard for the determination. See Wang Liming, *supra* note 25 at pp. 137–138.

[44] The fees provided by government or real estate developer to compensate the residents who have to be relocated to a new place because of government construction project or real estate development.

argument, one factor in determining whether the damages have been caused is whether the obligor's performance is being delayed.[45]

The third argument is a combination of the above two. It denotes the damages as both actual and possible damages caused by the obligor's failure to claim its creditor right so that the obligor may not have the assert or may not have enough asserts to satisfy its obligation to the obligee.

The Supreme People's Court seems to try to adopt a moderate approach that does not specify whether the damages are actual or likely ones. In the words of the Supreme People's Court, the damages to the interests of the obligee provided in Article 73 of the Contract Law refer to the non-satisfaction of the obligee's due creditor right as the consequences of the obligor's indolence in exercising its due creditor right and failure to claim the due creditor right of monetary payment against its debtor through the means of litigation or arbitration.[46] Interestingly, however, here the Supreme People's Court limits the claim via litigation or arbitration to the claim for monetary payment.

5.1.2. *Action to Seek Subrogation*

As noted, under Article 73 of the Contract Law, the exercise of subrogation right shall be made through an action in the court. In an action to seek subrogation, there are several procedural issues. The first issue is the court jurisdiction. Since the defendant in the subrogation action is the obligor's debtor (or secondary obligor), the court of the place where the obligor's debtor resides has the jurisdiction. The second issue is the pending lawsuit against the obligor. If the obligee has brought a lawsuit against the obligor, the subrogation action shall be suspended until the court decision is made for the said lawsuit against the obligor. The third issue concerns the obligor as the third party in the subrogation action. When the obligor is not listed as the third party to join the action for subrogation against the obligor's debtor, the court may add the obligor as the third party. The forth issue involves the request for attachment on the property of the obligor's debtor. In order to help ensure the enforcement of the court judgment against the obligor's debtor, the obligee in the subrogation action may ask the court to attach the property of the obligor's debtor. But when making such a request, the obligee is required to provide comparable amount of property guarantee.[47]

5.1.3. *Defenses of the Obligor's Debtor*

In the litigation for subrogation, as the defendant, the obligor's debtor may have different defenses against the obligee. One defense is to deny the obligee's allegation about the obligor's indolence in exercising the due creditor right of the

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[45] See Wang Liming, *supra* note 25 at pp. 139–143.

[46] See Supreme People's Court, *supra* note 40 art. 13.

[47] See *id*., articles 14, 15, 16, and 17.

obligor. If the obligor's debtor believes that the obligor has done nothing inappropriate to claim its creditor's right, the obligor's debtor may assert accordingly. It is important that when making the denial, the obligor's debtor bears the burden of proof as a matter of law.[48]

Another defense that the obligor's debtor may have against the obligee is its own defense against the obligor. Since in the subrogation action, the obligee is allowed to step into the shoes of the obligor to make a claim against the obligor's debtor, any defense that the obligor's debtor may have against the obligor would necessarily be asserted against the obligee. Of course, the obligor itself may also challenge the obligee's creditor right in the subrogation action, and if the challenge is successful, the action will then be dismissed.[49]

5.1.4. *Legal Effect of Subrogation Action*

If an action for subrogation is established and a court decision is made in favor of the obligee, the obligor's debtor shall make the performance to the obligee to the extent that the obligee's creditor right is fully satisfied. And after the performance, the creditor-debtor relationship between the obligee and obligor and between the obligor and the obligor's debtor will be extinguished. With regard to litigation fees incurred in the subrogation action, if the obligee wins the action, the fees, according to the Supreme People's Court, shall be borne by the obligor's debtor.[50]

As required by Article 73 of the Contract Law, the subrogation shall be exercised within the scope of the creditor right of the obligee. Thus, if the monetary amount in the obligee's subrogation request exceeds the debt the obligor owed to the obligee or the debt the obligor' debtor owed to the obligor, the exceeded part will not be considered by the court in the subrogation action. If, however, the obligor wants to sue its debtor for the residual amount of the debts after the obligee's creditor right has been satisfied, the obligor would have to file a separate action in a competent court for this purpose.[51]

5.2. Right of Cancellation

The right of cancellation is another right granted to the obligee by the law to protect the obligee's contractual interests. The right as such is to be exercised where the obligor intentionally gives away or reduces its assets in order to

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[48] See *id*., art. 13.
[49] See *id*., art. 18.
[50] See *id*., art. 19.
[51] See *id*., articles 20 and 21.

evade its debt obligations and as a result the obligee's creditor right is harmed. In this case, the obligee may ask the court to intervene and through the judicial proceeding to cancel the transactions between the obligor and the third party who receives the assets. By "taking back" the assets of the obligor, the cancellation is aimed at restoring the obligor's performance ability to satisfy the obligee's creditor right. Once again, like the right of subrogation, the cancellation right may only be exercised through an action in the court.

The theoretical base for the right of cancellation is the subject of on-going discussions among Chinese scholars. One point of view regards the right of cancellation as the right of claim, which means that the obligee has the right to ask a third party beneficiary to return the gained benefits. The right of claim occurs when the obligor transfers its assets to a third party at an unreasonably low price and the obligee may ask the third party to return the asserts so transferred in order to protect the obligee's interests. Others take the position that the right of cancellation is derived from the need for achieving the balance of interests between obligor and obligee. Some also argue that the right of cancellation is the device created by the law to safeguard the legitimate creditor right of the contract. Despite the differences, it is agreed that the primary purpose of cancellation right is to help realize the creditor right of the obligee.[52]

In accordance with Article 74 of the Contract Law, the cancellation may be requested under two circumstances. First, if the obligor renounces its due creditor right or transfers its property rights gratis, thus damaging the interests of the obligee, the obligee may request the people's court to cancel the obligor's act. Second, if the obligor transfers its assets obviously at an unreasonably low price, thus damaging the interests of the obligee, of which the transferee has the knowledge, the obligee may request the people's court to cancel the obligor's act. In addition, Article 74 provides that the right of cancellation shall be limited to the scope of the creditor right of obligee, and necessary expenses incurred to the obligee in exercising the right of cancellation shall fall on the shoulder of the obligor.[53]

Under Article 74 there are three factors that are critical for the exercise of the right of cancellation. The first factor is the obligor's conduct of renouncing its creditor right or transferring its assets, including a transfer gratis and a transfer at unreasonably low price. The second factor is the obligor's bad faith associated with the renouncement or transfer of its assets. The implication of the bad faith is that at the time of renouncement or transfer of its assets, the obligor knows or ought to know that its conduct will affect its ability to perform the

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[52] See Dong Ling, *supra* note 11 at pp. 105–107; See also Wang Liming, *supra* note 25 at p. 158.

[53] See the Contract Law, art. 74.

contractual obligations owed to the obligee and consequently the obligee's creditor right will be damaged.[54] Note that in the case of transfer of assets the bad faith factor also applies to the third party who knows the purpose and the outcome of the transfer at the unreasonably low price. The third factor is the damage to the interests of the obligee. The damage refers to the un-satisfaction of the obligee's creditor right. Thus, as long as the obligor's conduct causes any incomplete performance of the obligor's obligations, the damage to the interests of the obligee will be found.

The effect of the cancellation is to avoid the transactions the obligor made with the third party that is purposed to frustrate the realization of the creditor interest of the obligee. According to the Supreme People's Court, in an action for cancellation of the obligor's act of announcing creditor right or transfer of its assets, the people's court shall make a determination on the claim made by the obligee. If the cancellation is granted, the obligor's act is null and void from the very beginning.[55] Consequently then, the third party is required to return the assets that it obtained from the obligor. There are two notable points from the Supreme People's Court opinion: (a) the cancellation shall be made by the court order and (b) the cancellation order has a retroactive effect – tracing back to the time the act was conducted.

Although the right of cancellation belongs to the obligee, the exercise of the right must be made timely, or otherwise the right may be extinguished. Under Article 75 of the Contract Law, the right of cancellation shall be exercised within one year from the day when the obligee is aware or ought to be aware of the causes for the cancellation. It is further provided that if the right of cancellation has not been exercised within five years from the day when the act of the obligor takes place, the right of cancellation is extinguished, regardless of obligee's knowledge of the causes for the cancellation. The statute of limitation as applied to the exercise of the right of cancellation is to protect the interests of the obligor in the context of maintaining the business stability and efficiency. Note that the one-year limit is based on the obligee's notice of the obligor's act, while the 5-year limit deals with the actual occurrence of the obligor's act, whichever comes first controls.

The case below involves both the right of subrogation and the right of cancellation. Normally, the action for subrogation and the action for cancellation are deemed as separate causes of actions and ought to be litigated separately because in China the right of cancellation is characterized as "action for

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[54] Some argue that under Article 74 of the Contract Law, the bad faith is assumed from the obligor's conduct. If the obligor's conduct causes damage to the interests of the obligee, the obligor will be deemed to have acted in bad faith. See Dong Ling, *supra* note 11 at p. 114.

[55] See Supreme People's Court, *supra* note 40, art. 25.

confirmation" (*actio confessoria*) and the right of subrogation is "action for payment". In this case, however, the court combined the two actions and adjudicated them together.

China Agriculture Bank, Zhang Ping City Branch
v.
Zhang Ping Shuang Yang Supply & Sales Cooperative and
Zhang Ping City Agricultural Capital Company, Inc.

The High People's Court of Fu Jian Province
Ming Jing Zhong Zhi (2002) No. 290[56]

This case was appealed by appellant (plaintiff in the trial) from the judgment of Funjian Nongyan City Intermediate People's Court, *Yan Jing Chu Zhi* (2001) No. 083.

The basic facts of the case are as follows: On September 30, 1999, December 18, 1999 and March 31, 2000, defendant Agricultural Capital Company, Inc. (Agricultural Capital) borrowed RMB 2.45 million, 1 million and 4 million respectively from plaintiff, and defendant then defaulted in repayment of the loans. Plaintiff took a legal action against defendant Agricultural Capital and a judgment was entered in favor of plaintiff on December 8, 2000 by Funjian Nongyan City Intermediate People's Court, *Yan Jing Chu Zhi* (2000) No. 71. Under that judgment, it was determined that defendant Agricultural Capital owed to plaintiff in a total amount of RMB 7.45 million plus interests. After the judgment, defendant Agricultural Capital only paid to plaintiff the interests of RMB 53,767 and was unable to pay the principal due to its financial inability to satisfy the judgment.

Defendant Agricultural Capital and defendant Zhang Ping Shuang Yang Supply & Sales Cooperative (SS Cooperative) had a long-term business relationship, and defendant Agricultural Capital was a holder of a creditor right against defendant SS Cooperative. On December 16, 2000, SS Cooperative and Agricultural Capital sign "the Agreement of Debts Offset with Properties" under which SS Cooperative sold to Agricultural Capital its Sawmill and other two warehouses at the price of RMB 1,048,038. On December 5, 2001, plaintiff sued the two defendants for their conspiracy to evade debts owed by Agricultural Capital to plaintiff on the ground that the actual value of the said properties was far less than the price specified in the Agreement.

Plaintiff claimed that the sale of the properties by defendant SS Cooperative to defendant Agricultural Capital was a setup manipulated by the defendants in bad faith and the whole purpose was to frustrate plaintiff's creditors right against defendant Agricultural Capital. Plaintiff asserted that defendant SS Cooperative owed to defendant Agricultural Capital in the amount of RMB 1,048,083, and defendant Agricultural Capital did not duly exercise its creditor right, but rather it colluded with defendant SS Cooperative to offset the debts by selling three buildings of defendant SS Cooperative to defendant Agricultural Capital.

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[56] This case is selected in the National Judicial College & People's University Law School, *An Overview of the Trial Cases of China* (Volume of Commercial Cases 2004), 19 (People's Court Press and People's University Press, 2005).

Plaintiff argued that its creditor right was harmed by the deal between the defendants because given the fact that the real value of the Sawmill was no more than RMB 219,000, one warehouse was only worth RMB 127,000, and the other one was already occupied by other entity, the offset was actually a disguised form of defendant Agricultural Capital's renouncing its creditor right against defendant SS Cooperative. Plaintiff requested the court (a) to cancel the Agreement of Debts Offset with Properties reached by the defendants and (b) to order defendant SS Cooperative to promptly pay off the debts of RMB 1,048,083 owed to defendant Agricultural Capital.

Defendant Agricultural Capital argued that plaintiff's request had no legal ground because the Agreement of Debts Offset with Properties it entered with defendant SS Cooperative was legal and valid, which did not infringe any interests of a third party. Defendant Agricultural Capital asked the court to dismiss plaintiff's claim for the reason that it was not indolent in exercising its creditor right, and on the contrary, it had actively engaged in urging SS Cooperative to repay the debts, and the Agreement of Debts Offset with Properties would best serve as a strong evidence in this regard.

Defendant SS Cooperative insisted that the Agreement of Debts Offset with Properties was a manifestation of the real intention of the parties to clear up the debts it owed to Agricultural Capital and the Agreement should be held valid because the value of the properties was determined on the basis of appraisal, and the transfer of the properties affected no interests of a third party. Defendant SS Cooperative also argued that plaintiff's exercise of the right of cancellation was groundless since the creditor-debtor relationship it had with Agricultural Capital would no longer exist after the full payment it made to Agricultural Capital through the valid sale of the properties to satisfy the debts in question. Defendant SS Cooperative further rebutted that plaintiff's assertion of the debt amount of RMB 1,048,083 was not supported by any evidence, and therefore there was no legitimate reason to support plaintiff's subrogation right.

It was found during the trial that as of January 1, 2001, SS Cooperative owed Agricultural Capital in a total amount of RMB 801,296.90, which was evidenced by the detailed ledger account of SS Cooperative, dated June 30, 2001, stating that SS Cooperative paid Agricultural Capital RMB 801,296.90. It was also found that defendant Agricultural Capital owed plaintiff the debts of 7.45 million in total plus interests, and Agricultural Capital was financially incapable to pay off the debts, but it held matured creditor right against SS Cooperative. A further finding during the trial was that the actual value of the Sawmill and one warehouse, as appraised by the court designated appraisal agent, was RMB 346,000 all together, and the other two warehouses were possessed by other units, for which defendant SS Cooperative was compensated RMB 30,000. In addition, after defendant Agricultural Capital and defendant SS Cooperative singed the Agreement of Debts Offset with Properties on December 16, 2000, they did not close the deal and no settlement was ever made. In fact, however, on December 18, 2000, defendant Agricultural Capital leased back one warehouse to defendant SS Cooperative at a annual rent of RMB 1,000.

The trial court then held that there was no sufficient evidence to prove plaintiff's assertion of RMB 1,048,083 debts owed by defendant SS Cooperative to defendant Agricultural Capital, and then the actual amount must be based on the defendant SS Cooperative's ledger account, which was RMB 801,296.90. The court reasoned that absent evidence to the contrary, the record on the ledger account should be assumed to be the one that truly reflected the transactions between the defendants.

The trial court further held that the swap of the debts with the properties between the defendants was in fact intended to reduce the assets of defendant Agricultural Capital because the total value of the sold properties as appraised was unreasonably below the sale

price of RMB 1,048,083, and by doing so defendant Agricultural Capital actually abandoned its due creditor right against defendant SS Cooperative. In addition, the facts of no-settlement of transactions and low rent of one warehouse to SS Cooperative clearly implicated that the transactions were never really executed and defendants colluded with each other in bad faith in order to evade the debt obligations of defendant Agricultural Capital. On this ground, plaintiff's request to exercise the right of cancellation under the provision of Article 55 of the Contract Law should be granted.

The trial court also came to a conclusion that although the agreement of defendants to offset the debts with properties between them ought to be cancelled due to their bad faith collusion, defendant Agricultural Capital still held the creditor right against defendant SS Cooperative for the debt of RMB 801,296.90, and the fact of signing the agreement between the defendants demonstrated that the debts were already matured. Thus defendant's failure to actively exercise its matured creditor right through litigation or arbitration would constitute an indolence that damaged plaintiff's creditor right, which allowed plaintiff to exercise the right of subrogation.

The trial court then entered into the following judgment in favor of plaintiff:

1. The Agreement of Debts Offset with Properties reached by the defendants on December 16, 2000 should be cancelled;
2. Defendant SS Cooperative shall within 10 days after the judgment takes effect pay plaintiff RMB 801,296.90 that defendant SS Cooperative owed to defendant Agricultural Capital plus interests accrued from January 1, 2001 to the date of payment at an official rate set forth by the People's Bank of China for late payment; and
3. The litigation fees of RMB 22010 should be born by plaintiff in the amount of RMB 4010 and defendant SS Cooperative RMB 18,000.

Defendant SS Cooperative timely appealed the trial court judgment to this court. Defendant SS Cooperative argued that (1) the trial court erred in finding the transfer of the properties as defendant Agricultural Capital's abandonment of its creditor right, (2) SS Cooperative's internal ledger account should not be used as the basis for entering the judgment; and (3) the court's determination of defendant Agricultural Capital's indolence in pursing its creditor rights was not supported by sufficient evidence.

We, however, agree with the trial court that it is permissible to use the internal ledger account to help court make decision on the actual amount of debts, and as of January 1, 2001, the matured creditor right defendant Agricultural Capital had against defendant SS Cooperative was RMB 801,296.90. We find that defendant Agricultural Capital's did not actively take every measure to urge defendant SS Cooperative to pay the already matured debts that should have been paid, but instead it conspired with defendant SS Cooperative to sign a so-called "the Agreement of Debts Offset with Properties". We therefore hold that defendant Agricultural Capital's indolence and its bad faith collusion with defendant SS Cooperative indeed constituted a covert act of renouncement of its due creditor right against defendant SS Cooperative, and such act has caused damages to plaintiff's credit right.

Therefore, in accordance with Article 153(1)(a), it is ordered that the appeal be denied and the judgment below be confirmed. In addition, the appellant shall bear the cost of RMB 16250 to cover the fees for the appeal.

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China Agriculture Bank is the case where the courts uphold the right of cancellation and right of subrogation by focusing on the intent and conduct of

defendants to determine the bad faith collusion to evade the matured debts. Note that in this case the courts seem to suggest that the matured creditor right be exercised through litigation or arbitration or otherwise the right may be deemed as having not been actively exercised.

6. Guarantee of Performance

In addition to the rights of subrogation and cancellation, the parties may set fort through agreement a guarantee to ensure the performance of the contract. In addition, the guarantee for performance of the contract may also be provided by the law (e.g. lien). Because of its purpose to ensure that the contract is to be performed, the performance guarantee is also called guarantee of contract. At present, the primary legal source for the performance guarantees is the 1986 Civil Code. Under the Civil Code, a performance guarantee, made by the agreement of the parties or by operation of law, may take the form of suretyship, security interest, money deposit or lien. In addition, the establishment of guarantee is subject to the Guaranty Law of the People's Republic of China.[57]

6.1. Suretyship

Suretyship is a personal guarantee provided by a third party to the obligee to ensure that the contract obligations will be performed. Such a personal guarantee is based on the third party's credibility or assets, and in case where the obligor defaults in performance, the third party as a guarantor is obligated to perform for the benefit of the obligee or will be held jointly liable for breach of the contract. Under Article 89 (1) of the Civil Code, a guarantor may guarantee to the creditor that the debtor will perform its debt obligation. If the debtor fails to perform, the guarantor shall perform the debt obligation or jointly and severally bear the liability as agreed. After performing the debt obligation, the guarantor shall have the right for indemnity against the debtor.

To provide suretyship, the guarantor may be a legal person, other organization or citizen who is capable of assuming debts. But no government agency or pubic affairs institute may serve as the guarantor in commercial contracts.[58] In addition, the branches or functioning departments of a business company also may not act as guarantor unless authorized expressly in writing by the

[57] The Guaranty Law was adopted on June 30, 1995, effective October 1, 1995.

[58] Pursuant to the Guaranty Law of China, a government agency, as approved by the State Council, may act as a guarantor in the case of securing loans, for re-lending, from a foreign government or an international economic organization.

company to the extent authorized. According to the Supreme People's Court, a suretyship made by the branch of a company shall generally be deemed invalid, but the branch shall bear the property liability incurred thereof. If however the branch is insolvent, the liability shall be borne by the company.[59]

There is a statutory requirement for the creation of suretyship. Under Article 13 of the Guaranty Law, to create a suretyship, a written contract shall be made between guarantor and obligee.[60] It is also required in Article 15 of the Guaranty Law that the suretyship contract shall include the follows contents: (a) type and amount of the principal claim guaranteed, (b) the time limit for the debtor to perform the obligation, (c) methods of guaranty, (d) scope of suretyship, (e) term of suretyship, and (f) other matters the parties deem appropriate.

6.2. Security Interest

In order to guarantee the performance of contract, the parties may agree that obligor or a third party provides obligee with certain property as security from which the obligee may be compensated in case the obligor defaults. In China, the security interest is divided into two major categories: mortgage and pledge. Mortgage is defined as the interest in real property or right to the use of land that is provided by the obligor or a third party to obligee to guarantee the debts without transferring the right of possession of the property. It should keep in mind that no land but right to the use of the land may be used as mortgage in China. Pledge, also termed as pledge of movables, means that the obligor or a third party transfers the possession of his movables to the obligee as a security for debts. The movables include negotiable instruments (e.g. stocks).

As provided in Article 89 (2) of the Civil Code, the obligor or a third party may offer a specific property as security for the performance of obligations. If the obligor defaults, the obligee shall, in accordance with the provisions of law, be entitled to using the property in security to offset the debts or to having the priority in payment out of the proceeds from the sale of the property pledged. Because of the requirement for the transfer of the possession of the pledged property, the pledge will not take effect until the delivery of the property. In addition, if the pledge consists of negotiable instruments, the right to the exclusive use of trademarks, the property right in patents or copyright, which are transferable under the law, a registration is required in order for the pledge to become effective.

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[59] See Supreme People's Court, *Opinions on Implementation of the General Principles of Civil Law of the People's Republic of China (1988)*, art. 107.

[60] The Supreme People's Court seemed to be flexible about the writing requirement. It is held that the oral guarantee between citizens, if witnessed by more than two uninterested people, will be deemed as a guarantee contract, unless otherwise provided by law. See *id*, art. 108.

6.3. Money Deposit

Money deposit, or earnest money, is a security in the agreed amount of money to guarantee the obligee's creditor right. Under Article 89 (3) of the 1986 Civil Code, within the limits of the law, the parties to a contract may agree that one party deposits with the other party certain amount of money as a guarantee to perform the contract. The money so deposited shall be refunded or credited against the contract price after the contract obligations are performed. The depositor shall have no right to reclaim the money if its fails to perform the contract obligations. If, however, the party who receives the deposit fails to perform, he is required, as a penalty, to double refund the deposited money.

Article 90 of the Guaranty Law mandates that the deposit money be executed in writing. And in the writing, the parties shall specify the time limit for the delivery of the deposit, and the written agreement for the deposit shall be effective on the date of actual delivery of the deposit. Pursuant to Article 91 of the Guaranty Law, the parties are fee to determine the money amount for the deposit, but the amount is capped at 20% of the total price of the contract.

6.4. Lien

The parties to a contract may also provide a lien by agreement to ensure the performance of contract obligations. The lien is defined in Article 82 of Guaranty law to mean the obligee's possession of obligor's movables, under which the obligee may retain the property or have the priority in payment out of money converted from the property or the proceeds from sale of the property or auction. The main difference between lien and pledge is that the property under lien is in the possession of the obligee before or on the date when the creditor right is created, while the pledge involves the transfer of property on or after the creation of the creditor right. In addition, the lien may only be made on the property of obligor, but the pledge may be placed on the property of a third party.

According to Article 89 (4) of the 1986 Civil Code, if a party has possession of the other party's property according to the contract and the other party violates the contract by failure to pay the required sum of money within stipulated time period, the possessor shall have the right of lien against the property and thereby may retain the property to offset the debts or have the priority of being compensated out of the proceeds from the sale of the property. The contracts in which the obligee normally has the right of lien in case of obligor's failure to perform are the contracts for storage, transportation or processing.

7. Changes of Circumstances During Performance

In the Contract Law, two types of changes of circumstances are relevant when a contract is being performed. The first is the change related to the parties. The most common phenomenon is the change in the management, business structure, company name, or address. The change also includes merger or split-up of the company. The second is the circumstantial changes during the performance of the contact, which is unpredictable at the time of contract and could not be overcome after the occurrence. The circumstantial changes involve a popular doctrine of *Rebus Sic Stantibus.*

7.1. Change related the Parties

Under Article 76 of the Contract Law, after a contract becomes effective, the parties may not refuse to perform the obligations of the contract because of the change of the title or name of the parties, or change of the legal representative or person-in-charge of the parties.[61] The importance of Article 74 is to preserve the consistence and continuance in performance of contract obligations regardless of the change in personnel or company structures of the parties. The purpose is to prevent the party or parties from evading contract obligations by making changes in the company or business settings.

On the other hand, the Contract Law requires the obligee to provide the obligor with a notice about all the changes that may affect the obligor's performance. Under Article 70 of the Contact Law, if the obligee does not notify the obligor its separation, merger or a change of its domicile so as to make it difficult for the obligor to perform the obligations, the obligor may suspend the performance of the contract or have the subject matter of the contract submitted to the relevant authority.[62] In this situation, the obligor will be excused for being held liable for breach of contract. Additionally, if the performance is suspended for this reason, the obligee shall bear the risk that the subject matter of the contract may encounter (e.g. loss of value), and may also be liable for damages resulting from the late acceptance of the performance.

7.2. *Rebus Sic Stantibus*

One of the most controversial issues in drafting the Contract Law is whether the doctrine of *rebus sic stantibus* should be incorporated into the Contract Law. Under this doctrine, one party may be excused from performance when

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[61] See the Contract Law, art. 76.

[62] See *id*., art. 70.

a change in circumstances beyond the contracting parties' expectation and control has frustrated the original basis of the contract so that the continuing performance would obviously render unfairness, and as a result it is necessary to have the contract modified or rescinded.

Although *rebus sic stantibus* was not provided in any previous contract legislation, it was accepted in judicial practice. In *Wu Han Gas Company v. Chongqin Testing Instruments Factory* (1989), Plaintiff entered into a contract in 1988 with Defendant for purchasing 70,000 sets of J 2.5 gas meters at RMB 57.30 per set. The contract provided that defendant should deliver 30,000 sets of the meters in 1988 and 40,000 sets in 1989 to plaintiff. All meters were made of aluminum. Several months after the contract was concluded, the price of aluminum was adjusted by the States from RMB 4400–4600 per ton to 16,000 per ton. Consequently, the cost for producing the meters was increased to RMB 79.22 per set. When defendant asked to modify the contract or rescind it in order to avoid heavy loss, plaintiff refused. After defendant stopped delivering the meters, plaintiff sued for breach of contract.

At trial, Wuhan Intermediate People's Court entered a judgment against defendant. The Court held that the change of price did not constitute a valid ground for defendant not to perform its contractual obligations, and defendant was therefore fully liable for the breach. On appeal, the judgment was reversed by the High People's Court of Hubei Province. In remanding the case for further proceeding, the High Court was of opinion that if during the performance of the contract there was a material change which the parties could not have foreseen at the time when the contract was made, and if continuing performance would be manifestly unfair, the doctrine of *rebus sic stantibus* should be applied to help maintain the notion of fairness.[63]

The Supreme People's Court endorsed the opinion of the High People's Court of Hubei Province. In its letter of judicial instruction issued on March 6, 1992,[64] the Supreme People's Court held that for purposes of the instant case, due to the chance in circumstances that could not be foreseen and prevented by the parties during the performance of the contract, it would be obviously unfair if defendant was asked to continue performing its obligations according to the original contract. In 1993, the Supreme People's Court further pointed out that if due to the reasons for which none of the parties may be blamed, an unpredictable change in the circumstances on which the contract

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[63] See Kong Xiangjun, Comments and Theoretical Study on Difficult Cases of the Contract Law (Revised Ed), 396 (People's Court Press, 2000).

[64] The letter of judiciary letter from the Supreme People's Court is normally used by the Court to answer legal questions raised by a High Court concerning interpretation and application of specific law or regulation in a particular case. See *id*.

is based is so fundamental that it would be obviously unfair to enforce the original contract, the people's courts may, upon the request of the parties, modify or dissolve the contract under the doctrine of *rebus sic stantibus*.[65]

During the early stage of the drafting of the Contract Law, the *rebus sic stantibus* doctrine was included. It, however, was strongly criticized by opponents. They argued that the doctrine might be abused if provided in the Contract Law because (1) there is no commonly accepted definition for *rebus sic stantibus*; and (2) it is very difficult, if not impossible, to draw a line between *rebus sic stantibus* and normal commercial risk. As a result, the doctrine was ultimately dropped out from the final draft of the Contract Law.[66]

Consequently, the lack of actual legislative endorsement casts serious doubt on the validity of the future use of *rebus sic stantibus*. The dilemma will be whether the Supreme People's Court's previous opinion in favor of this doctrine would have any meaningful impact on the lower courts' future decision in the similar cases. In other words, until the Supreme People's Court says something differently, will the doctrine of *rebus sic stantibus* be still recognized in judicial practice based on the Court's above holding even though the Contract Law does not provide so?

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[65] See Supreme People's Court, "*Minutes on 1993 National Symposium on Trials of Economic Cases*", May 6, 1993 Fa Fa (1993) No. 8.

[66] See Sun Lihai, *Selection of Legislative Materials of the Contract Law of the People's Republic of China*, 54–55 (Law Press, 1999).

Chapter VIII
Modification of Contracts and Assignment

On the notion that the contract is a product of free and voluntary negotiations of the parties to carry out their business goals, the parties who are capable to make the contract are capable to modify the contract. Of course, like creation of the contract, the modification of the contract is subject to certain conditions or limitations. In China, by definition, the contract modification has two meanings: modification in a narrow sense and modification in a broad sense. The modification in a narrow sense means the changes in the contents of the contract, including the amendment, supplement as well as limitation made to the terms of the contract. The modification in a broad sense includes in addition the change of the obligee and obligor of the contract, which generally means assignment and delegation.[1]

1. Modification

The contract modifications may result from the agreement of the parties or a court order. In the context of the Contract Law, the modifications are primarily made through the parties' agreement. Article 77 of the Contract Law provides

[1] In China, there seems no such a concept as novation. Although the change of parties is discussed in the contract law literature, the discussion is more associated with modification or assignment. In the U.S., A novation means to substitute a new party and discharges one of the original parties to a contract by agreement of all parties. See Restatement of Contracts (2nd), § 280.

that a contract may be modified if the parties reach a consensus through consultation.[2] The provision of Article 77 has several implications. First of all, the parties are free to modify the contract between them. Secondly, the modification shall be made by the agreement of the parties. And thirdly, the agreement for modifying the contract shall be reached by consensus of the parties on a voluntary basis through consultation. Again, consideration is not required in China to support the modification.

Generally, the validity of modification is governed by the same rules that determine the validity of the contract. Thus, although the parties may modify the contract as they wish, the modification is subject to certain restrictions. One restriction is the approval or registration requirement. Under Article 77 of the Contract Law, if the law or administrative regulations require that the modification to a contract shall obtain approval or registration, the requirement must be satisfied before the modification becomes valid. The approval or registration requirement for the modification is normally consistent with the contract itself. If a contact needs to be approved, the approval would be required for modification of the contract.

Another restriction concerns the writing requirement. The Contract Law is unclear about whether writing is required for the modification. But pursuant to the "consistence" approach, the modification may have to be made in writing if the contract is made in writing in order to be consistent as between the contract and its modification. As a commonly accepted principle, the formality requirements that apply to the formation of a contract will generally be applied to the modification of the contract. However, since the Contract Law does not mandate the writing for modification, the court may uphold an oral modification if the parties admit. But as a practical matter, to modify a contract, writing is critical and desirable because the writing will serve as the best evidence to prove that the contract is being modified.

The legality is also a restriction on the modification. A modification may not violate the legality requirement of the contract. That is to say that a modification shall not make the contract to contain any illegal contents. This restriction is entirely based on the public policy concerns against excessive pursuit of individual self-interest of the parties or in a more general sense abuse of right by the parties. Conversely, the legality requirement for the modification as applied to the contract is to ensure that the contract is not undertaken in any way in which the State or social public interests might be harmed.

There are two doctrines advocated in China concerning the modification of the contract. One doctrine is "non-substantial change". Under this doctrine,

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[2] See the Contract Law, art. 77.

the modification is to make changes that are not substantial to the contract. If the change is substantial, it will then not be a modification but a replacement of contract. By replacement, it means that a new contract will take in the place of the existing contract. The changes that are substantial, in the view of non-substantial doctrine, include (a) the change of the subject matter of the contract, (b) the significant alteration of the amount of performance, and (c) the material variation of the contract price.[3] The Contract Law, however, contains no such distinction as between substantial and non-substantial change.[4]

The other doctrine is "unequivocal change." The basic notion is that the modification carries the consensual variation to the contract between the parties. Hence, because the modification involves the changes that may result in a mutual adjustment of rights and obligations between the parties, it is crucial that the changes agreed by the parties are unequivocal. The "unequivocal change" doctrine is adopted in the Contract Law. For example, Article 78 of the Contract Law explicitly states that if the contents of the modified contract agreed by the parties are unclear or uncertain, it shall be assumed that the contract is not modified.[5]

The primary legal effect of the modification is that the performance shall be made according to the modified contract because the contents of the contact have been changed as a result of modification, and the failure to perform the modified obligations will constitute a breach of the contract for which the party in breach will be held liable. In addition, the modification will only affect the performance afterwards, and has no retroactive effect on the obligations already performed. Consequently, the parties may not avoid the past performance on the ground that the contract has been modified.

A debatable question resulting from the modification of contract is whether the modification will affect the right of the parties to seek for damages. The question mainly involves the damages caused by one party to the other before the contract was modified. One argument is that the damages prior to the modification shall be dealt with by the parties in their negotiation for the modification. If the parties did not mention the damages in their modification

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[3] See Wang Liming, *Study on Contract Law (Vol. II)*, 194–195 (People's University Press, 2003). Some argue that the modification also contains the change of subject matter of the contract. See Wang Jiafu, *Obligatio in Civil Law*, 358 (Law Press, 1991).

[4] Some argue that the modification is actually to replace the existing contract with a new one because the modification contains both the change of parties to the contract as well as the change of the contents of the contract. It seems, however, that this argument confuses the modification with novation, and blurs the distinction between modification and assignment. See Dong Ling, *Performance, Modification, Assignment and Termination of Contracts*, 120–121 (China Legal System Publishing House, 1999).

[5] See the Contract Law, art. 78.

agreement, the aggrieved party may not ask for the damage after the modification is made because its right to seek for the damages is deemed to have been waived. The other argument insists that the modification shall not affect the party's right to damages regardless of the time at which the damages occur. The second argument is premised on Article 115 of the 1986 Civil Code, which provides that a party's right to claim compensation for damages shall not be affected by the modification or termination of a contract.[6]

But, those who uphold the first argument above try to narrow down the meaning of Article 115 of the Civil Code. They point out that the modification in Article 115 refers only to the modification made by court order or arbitral decision, excluding the modification by the agreement of the parties. Interestingly, however, although the supporters of this argument believe that the way in which the modification is made will lead to the different effect of the modification with regard to the prior damages, they take the position that the modification shall not affect the liability for breach of contract that occurred before the contract is modified.[7] The reason seems to be that however the modification is made it shall make no difference to the liability for the breach of contract, unless the parties specifically agree otherwise.

2. Assignment

As we have discussed at the beginning of this chapter, assignment is China is associated with modification and is deemed as the modification in a broad sense, namely the change of obligee or obligor. Thus, an assignment may take the form of transfer of contractual rights, contractual obligations, or both rights and obligations of a contract. Note that the term of assignment or delegation as used in China is commonly phrased as the transfer of contractual rights or transfer of contractual obligations, and in either situation, the transfer shall presuppose an existing valid contract. According to Chinese contract scholars, no contractual rights and obligations may be transferred without existence of a valid contract on which the rights and obligations are based. And even if there is a contract, the transfer of rights and obligations will be adversely affected if the contract becomes invalid.

The assignment was first provided in the 1986 Civil Code. Under Article 91 of the Civil Code, if a party to a contract transfers all or part of its contractual rights or obligations to a third party, it shall obtain the other party's consent

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[6] See the 1986 Civil Code, art. 115.

[7] See Wang Liming, *supra* note 3, at pp. 207–208.

and may not seek profits there from.[8] Based on Article 91, the assignment could be defined as a transfer by a party of all or part of its contractual rights or obligations to a third party. But clearly, while permitting a transfer of contractual rights or obligation to a third party, Article 91 of the Civil Code imposes two restrictions on the transfer. First, the transfer of either contractual rights or obligations made by one party must seek the consent of the other party, and second, the transfer shall not be made for the purpose of reaping profits.

The Contract Law, however, revises the Article 91 of the Civil Code with respect to the assignment. The revision is mainly in the following two respects: (a) the Contract Law eliminates the prohibition of "profit-seeking" imposed on the assignment, and (b) the Contract Law abandons the consent requirement for the transfer of contractual rights. In addition, the Contract Law separates the transfer of the contractual rights from the transfer of contractual obligations. Because of the discrepancy between the Civil Code and the Contract Law as applied to the assignment, it gives rise to a question about the application of law – which law controls. It is generally held that the Contract Law takes priority under both the doctrine of "late-in-time" and the doctrine of "special law".[9]

The following case helps explain how the issues of assignment of the contract are being handled in the people's courts. This case may not answer all issues involved in the assignment, but it states quite in length the reasons for the decisions made by the court to uphold the assignment that was in disputes, which normally may not be seen in the decisions of Chinese people's courts.

Shen Yang Xu Ke Group, Ltd.
vs.
Tie Ling No. 2 Group of Northeast Jin Cheng Construction Installation Co.

The High People's Court of Liao Ning Province[10]

On August 18, 1995, defendant entered into a contract with Shen Yang Railway Branch of China Construction Bank (Bank), under which the Bank will provide loan to defendant in the amount of RMB 4.9 million with an interest rate of 10.05% per month for a term of one year. The loan was guaranteed by Jin Cheng Co. Inc. (Guarantor) who promised to repay the loan if defendant defaults. After the contract of the loan was signed, the Bank transferred into defendant's bank account RMB 4.9 million on October 10, 1995.

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[8] See the 1986 Civil Code, art. 91.

[9] Under the "late-in-time" doctrine, if an inconsistence between the two legal provisions presents, the one adopted later is deemed to supersede the earlier one. And according to the "special law" doctrine, if there is a conflict between a provision of general law and the one of special law, the special law governs.

[10] See, the Civil Judgment of the High People's Court of Liao Ning Province, (2003) Liao Min 2 He Zhong Zhi No. 174.

However, after the repayment was due, both defendant and guarantor defaulted. On June 24, 1999, defendant and guarantor both acknowledge receipt of the notice of default issued by the Bank, and had affixed the company seals to the notice as their acknowledgement of the unpaid loan.

In November 1999, the Bank reached an agreement with Shen Yang Branch of Xin Da Assets Management Co. (Xin Da) to assign its creditor right of the contract with defendant to Xin Da. On November 3, the Bank and defendant singed a verification of debts, which confirmed that defendant owed to the Bank RMB 4.9 million and interest at 10.05%/month. On July 25, 2001, the Bank and Xin Da issued a public notice in "Liao Ning Daily" indicating the assignment and urging both defendant and guarantor to make prompt payment for the debts to Xin Da. Defendant, however, still made no payment.

On August 8, 2002, plaintiff acquired from Xin Da the creditor rights through a public auction at the price of RMB 1.8 million against 10 sums of bad debts, including the one owed by defendant. On September 5, 2002, Xin Da notified defendant of the auction and the assignment of the creditor rights to plaintiff. After several unsuccessful attempts to have defendant to pay the debts, plaintiff brought this action against defendant at Shen Yang City Intermediate People's Court. In its defense, defendant argued that the assignment of the creditor rights from Xin Da to plaintiff was illegal and therefore plaintiff had no standing to make the claim. The trial court entered a judgment in favor of plaintiff, holding that the transfer of creditor right through public auction is valid, and failure to pay the debts constitutes a breach of contract, for which both defendant and guarantor shall be held jointly and severally liable.

In reaching its decision, the trial court reasoned that the contract between defendant and the Bank and the agreement to guarantee the loan were both valid and enforceable, and by defaulting the payment for the loan, defendant and the guarantor breached the contract, which infringed the creditor right of the Bank. The assignment agreement between the Bank and Xin Da was also valid under the Contract Law because (a) it was reached on a voluntary basis, (2) its formality and contents did not violate the law, and (3) the Bank as the assignor performed its duty of notice. The trail court denied defendant's argument neglecting plaintiff's standing for the lawsuit on the grounds that the transfer of the creditor right from Xin Da to plaintiff through public auction was a valid transfer because the transfer, approved by relevant authority, conformed with then prevailing government policy and did not violate the law, and the notice of the transfer was properly given. In its judgment, the trial court ordered defendant to pay plaintiff the principal of the loan RMB 4.9 million and interest RMB 3,911,372.62, and also to bear the litigation fees in the amount of RMB 115,080.

On appeal, defendant challenged trial court ruling for the reasons that (a) the trail court erred in determination of the facts, and denied groundlessly defendant's right of first refusal, (b) the trial court made mistake in application of the Contract Law because the loan was made before the Contract Law took effect, and (c) the trial court violated the procedure law during the trial since the trial court ignored defendant request for a closer review of legality of the process of the transfer of the creditor rights in question. Defendant asserted that there was no legal basis to allow the Bank to impose penalty interest, and the trial court erroneously dismissed the fact that plaintiff and Xin Da conspired to commit illegal conduct in the transfer of creditor rights, which have caused harm to the state interest and infringed defendant interest for plaintiff's own gains.

Plaintiff argued that the transfer of the creditor right was valid and effective. Plaintiff's argument was based on the following reasons: (1) Xin Da, as a financial management institute, is an asset company duly authorized by the government to deal with all bad debts, and therefore has the right in whatever means it sees fit to dispose of the debts it

managed, including a public auction. Plaintiff acquired the Bank's creditor rights against defendant through auction, and the transfer met the requirements of the law. The whole transaction was therefore valid. (2) Before the transfer of the creditor right, Xin Da made a public notice in the provincial newspapers about the public auction, which contained a detailed description of defendant and its business situation. During the auction, defendant did no attend the bidding, and then was regarded to have given up its right to purchase. Thus there existed no infringement of defendant's right. (3) Defendant provided no evidence proving that plaintiff and the Bank had maliciously conspired to damage the interest of the State. (4) Since the agreement for the transfer of the creditor right was reached on August 30, 2002 and the Contract Law became effective on October 1, 1999, it is imperative that the Contract Law should apply.

This Court agrees with the trial court's finding that the assignment agreement between the Bank and Xin Da was valid, and the guarantor was jointly and severally liable to plaintiff for the debts owed by defendant. As far as the legality of the transfer of the creditor right from Xin Da to plaintiff is concerned, under the State Council "Regulations For Finance and Assets Management Companies", the asset company is the special entity created for acquiring, managing and disposing of the bad debts that the State owned commercial banks encountered. The asset company, when transferring the asset under its management, may take the form of invitation to bid or public auction. In the instant case, Xin Da chose to have the public auction to transfer the credit rights against defendant, whereby plaintiff obtained the rights. Such a transfer is authorized by the State Council Regulations, and therefore must be supported. On this basis, the Court concludes that defendant argument against the validity of Xin Da's transfer of the creditor right through the public auction must be denied.

Defendant's assertion of the right of first refusal shall also be defeated for the lack of legal ground. The Court holds that the right of first refusal is a legal right, which must be clearly addressed in the law. The current laws, however, contain no provision that would give the defendant the right of the first refusal in the case like the transfer of creditor right in question. With regard to the question concerning malicious conspiracy that causes harm to the State interest, it must be viewed within the four corners of the "Auction Law". Auction, as defined in the "Auction Law', is the means to transfer the specific item or property right in the form of public bidding to one who makes the highest bid. With regard to the value of transferred assets, because what the assert management company acquires are the bad debts from the State owned bank, there of course exists the difference between the original value and present value of the creditor right involved in the bad debts. Therefore, to transfer the creditor right of the State assets through public auction will not cause the State asset to lose, and on the contrary, it is the way in which the value of the State assets could be realized as much as possible. For this reason, the legitimate creditor rights plaintiff obtained from the public auction shall and must be protected.

Equally, Defendant's accusation that plaintiff conducted malicious conspiracy with Xin Da to harm the State interest in order to achieve personal gains shall also be denied because there is no any factual evidence to support the accusation. In addition, the trial court did not err in application of Contract Law to the agreement of transfer of the credit rights between plaintiff and Xin Da. The application is appropriate because the transfer agreement was signed after the Contract Law took effect.

For all reasons stated above, in accordance with Article 153 (1)(a) of the Civil Procedure Law of the People's Republic of China, it is so ordered:

The trial court judgment is affirmed with the appeal cost of RMB 62,285 to be paid by defendant. This judgment is final.

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In the *Xu Ke Group* case, the courts obviously focused on three basic requirements, namely voluntary basis, in compliance with the law and the duty of notice, in making the determination of the validity of the assignment pursuant to the provisions of the Contract Law. The courts decision also implicates that an assignment would normally be assumed valid unless it is proved that any of the three requirements is not met. We now turn to more detailed discussions on the assignment and its requirements

2.1. Assignment of Contractual Rights

For our discussion purposes, the term "assignment" is used to specifically mean the transfer of the contractual rights and the term "delegation" is employed to denote the transfer of contractual obligations, although in the Contract Law, no such distinctions are explicitly drawn. Conceptually, assignment in Chinese contract law literature is a consensual transfer of obligee's contractual right, and the relationship so created between assignor and assignee is a contractual relationship.

Under Article 79 of the Contract Law, the obligee may assign, in whole or in part, its rights under the contract to a third party.[11] Thus an assignment may now be defined as a transfer of valid contractual right, in whole or in part, by the obligee to a third party. According to the Contract Law, the assignment may be made gratuitous. As a result of the assignment, the assignor's interest in the contract will be extinguished to the extent that rights are assigned.

When an obligee assigns all of its contractual rights to a third person, the status of the assignee becomes a question among Chinese contract scholars. A seemingly popular opinion is that if an assignment is made in full the assignee is regarded to replace the assignor and become a party of the contract, and after the assignment, a new contract relationship is created between the assignee and the obligor, and the previous contract will cease to exist. Consequently, the obligor is obligated to make performance to the assignee, and the assignee obtains all claims that the assignor has against the obligor.[12] But many disagree by arguing that even if the whole contractual rights are assigned, the assignor may still be under the obligation to perform its contractual duties, if any, that the assignor is supposed to perform, because a full transfer of contractual rights by assignment may not necessarily cut off the assignor (obligee)'s contractual relationship with the obligor, but only take away the contractual rights that the assignor has.[13]

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[11] See the Contract Law, art. 79.

[12] See Wang Liming, *supra* note 3 at p. 217.

[13] See Yang Lixin, *Implication and Application of the Contract Law*, 153 (Jilin People's Publishing House, 1999).

The debate on the status of the assignor in the assignment may become practically relevant when a dispute arises between the assignee and the other party (obligor) of the contract over the contract performance. The question involves whether the other party (obligor) may have the claim against assignor or whether the assignor may remain liable if the assignee breaches the contract. Under Chinese contract concept, the parties to a contract are mutually obligated (except for the unilateral contract). Pursuant to the mutual obligation theory, in a contract a party is an obligee in one respect, and is an obligor in the other. The point is whether an assignment in full will necessarily break the mutuality of the contractual obligations between the parties to the contract.

To illustrate, a seller has a contract with a buyer, under which the seller will deliver the agreed amount of grains to the buyer on a specific day. With regard to the delivery of the grain, the seller is obligor and the buyer is the obligee. If, however, the payment is at issue, the seller will become the obligee and the buyer obligor. Obviously, when the seller assigns its right to the payment to C (a third party), the assignment may not necessarily make the seller home free, particularly if the grains that were delivered to the buyer turned out to be defective or not conformed with the terms of the contract.

The assignment in part concerns a partial transfer of the obligee's contractual rights. Because the obligee does not assign all of its contractual rights to a third party, the third party will join the assignor as a co-obligee after the assignment, and then the obligor will make its performance to both the obligee (assignor) and the third party (assignee) who comes into the picture as a result of the assignment. There has been a concern that the partial assignment will actually increase the burden of performance on the obligor since the obligor may have to deal with more obligees after the partial assignment. For this reason, it has been criticized that the Contract Law allows partial assignment, but provides no specific rules.

It may be hard to tell the nature of the partial assignment with regard to the relationship between the assignor and assignee. Basically, due to a partial assignment, the assignor and assignee possess a co-ownership of the contractual rights, and each party is entitled to certain interests in the rights. But the extent to which the parties divide their interests in the contractual rights is dependent on how the co-ownership is to be formed. In this regard, the nature of the partial assignment may perhaps be the question about the type of the co-ownership. In fact, many scholars in China prefer to classify such co-ownership into two categories: ownership in common and joint ownership.[14]

The ownership in common is also termed as ownership by shares. Under the ownership in common, the assignor and assignee will enjoy the contractual rights according to the agreed shares of the interests in the contract. When the

[14] See Yang Lixin, *id*., at pp. 152–153.

ownership of the contractual rights is in common, the assignor and assignee may only have the claim in proportion to their own shares, and may not reach beyond that. Conversely, the obligor may perform the duties to assignor and assignee separately and the performance made to assignor may not be deemed as the one to the assignee. Consequently, the acceptance of the performance exceeding the shares of the interest by either assignor or assignee will be deemed as unjust enrichment and is therefore subject to restitution.

The joint ownership is different. The major distinction is that it makes the contractual rights indivisible. If the partial assignment creates a joint ownership, the assignor and assignee will jointly and severally own the interest in the contractual right. An interest being joint and several would mean that either assignor or assignee has the right to request the obligor to make a full performance of the contact. Based on the joint ownership, the obligor may perform all of the contract obligations to either assignee or assignor, and completion of the performance will satisfy the creditor right of both assignor and assignee.

Generally, when making the assignment, the parties may in the assignment agreement specify the type of ownership. Since the ownership in common involves particular amount of shares that the assignor and assignee may have, an agreement on the division of the shares between the assignor and assignees is normally required. Therefore, if no specification is made in the assignment agreement or the specification is unclear, the joint ownership will be assumed.

In the Contract Law, there is also a lack of provision concerning the multiple assignments of same right. Because the Contract Law does not prohibit the multiple assignments, many suggest that a contract right may be assigned more than once. But the question in the multiple assignments is who gets the priority among the assignees. There are two approaches that have been proposed. The first one is the approach of "order of assignment". Under this approach, the priority among the assignees shall be determined by the order of assignment, which means that the first assignee shall have the priority over all subsequent assignees.[15] In addition, the "order of assignment" approach contains two "supplementary orders", namely, the assignment for value prevails over the gratuitous assignment, and assignment in whole has the priority over the assignment in part.

Another approach is termed as the "order of notice". This approach is actually based on the so-called "English Rule", which provides that the first assignee to give notice to the debtor prevails.[16] The theory underlying the

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[15] See Wang Liming & Cui Jianyuan, *A new Commentary on Contract Law – General Provisions* (Reversed Ed), 424 (China University of Political Science and Law Press, 2000).

[16] For the general discussion on the "English Rule", see Rohwer & Schaber, *Contracts In A Nut Shell (4th ed)*, 373 (West, 1997).

"order of notice" approach is that the assignee will not obtain the rights assigned until the obligor is notified of the assignment.[17] Therefore, the "order of notice" approach is essentially the scheme of race notice, which means that whoever provides notice first has the better position of claim regardless of the order of assignment.

A related issue is the assignment of future interest in the contractual rights. The future interest refers to the interest that may appear in the future depending on the occurrence of certain facts, e.g. the guarantor's right of indemnity against obligor, or the interest that will be realized when the agreed condition is satisfied or the time for the interest to arise comes. The future interest may also be the expected interest that the parties agree to gain in the future. The Contract Law is silent about this issue. One major reason is that the future interest is deemed as too speculative to be certain. But it has been argued that although the future interest seems uncertain at the time of assignment agreement, it may still be assignable because if the contractual rights are certain, the future interest that will derive from the contractual rights may not necessarily be speculative.[18]

2.1.1. *Formality of Assignment*

Since assignment is a manifestation of the intent of the obligee to transfer its contractual rights to a third party, it is essential that the assignment be made by agreement. But the Contact Law does not impose a writing requirement on the assignment agreement, nor is there any special formality the parties have to follow to make the agreement for assignment. Therefore, the contractual rights in China may be assigned in the way both assignor and assignee may see fit as long as the agreement is made voluntarily between the parties in assignment. An exception is the statuary requirements for approval or registration. According to Article 87 of the Contract Law, if the laws or administrative regulations provide that an approval or registration is required for the assignment of contractual rights, such requirement must be met.[19]

As we have mentioned, the Contract Law repeals the requirement of the obligor's consent to the transfer of the obligee's contractual rights. However, in order for an assignment to take effect, the Contract Law mandates a notice to the obligor. Under Article 80 of the Contract Law, an obligee, when assigning its contractual rights, shall notify the obligor. Without such a notice, the assignment shall have no effect as to the obligor.[20] The notice may be made

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[17] See Wang Liming, *supra* note 3 at p. 238.
[18] See Dong Ling, *supra* note 4 at pp. 138–139.
[19] See the Contract Law, art. 87.
[20] See *id*., art. 80.

orally or in writing. But pursuant to the "consistence" rule, if the contract was made in writing, the assignment of the rights in the contract shall also take a written form. The written assignment may also be needed if so provided by the law or administrative regulations.

Article 80 of the Contract Law makes it an obligation of the obligee to send the notice to the obligor concerning the assignment. With regard to the time of the notice, however, it is not specified in the Contact Law. There are two issues related to the time: the first issue is when the notice will be effective as to the obligee, and the second is when the notice should be sent out to the obligor. As far as the effective time is concerned, an analogical application of the offer rules of the Contract Laws implies that the notice of assignment is effective upon its arrival at the obligor. The issue as to when the notice should be sent out seems less important practically because there would be no valid assignment until the notice is sent to the obligor. Again, since Article 80 imposes no restriction on the form of notice, and therefore, the notice may be made either in writing or orally.

There is a rule that an assignment becomes irrevocable when the notice of the assignment is sent. According to Article 80 of the Contract Law, the notice of the assignment of the rights may not be revoked unless the assignee agrees thereupon.[21] Thus, once the assignment notice is dispatched, the revocability of the assignment is in the hands of the assignee. A problem is, however, that since the notice of the assignment is irrevocable after it is sent, it seems meaningless to base the effectiveness of the assignment on the arrival of the notice because the assignor may not be able to do anything that may affect the assignment after the notice is sent even if the assignor has the time to take the notice back before the assignee receives it.

2.1.2. *Non Assignable Rights*

Generally, the assignor may assign all of its rights arising from a contract. But there are certain circumstances under which no assignment of the rights of a contract may be made. Under Article 79 of the Contract Law, the contractual rights may not be assigned if the rights are non assignable (a) due to the nature of the contract, (b) pursuant to the agreement between the parties, or (c) as provided by law.[22] It then seems logical to conclude that other than those listed in Article 79 of the Contract Law, all rights in a contract are assignable in China.

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[21] See *id*.

[22] See the Contract Law, art. 79.

The nature of contract refers to the distinction or character of contract. A contract is not assignable by nature if it is made between the parties on the basis of personal distinctions or particular relations, and the performance will be materially altered or the value of the performance will be substantially reduced when any right of the contract is assigned to a third party. Generally, there are three kinds of contractual rights that are deemed to fall within this category: (1) the rights that are premised upon personal trust and credibility, such as employment contract or agency; (2) the rights arising from personal service contract, e.g. contract for entertainment performance; and (3) subordinate rights, namely the rights dependent on the main rights of the contract, e.g. the rights out of a guaranty contract.

A contract may also not be assigned if the parties by agreement prohibit the assignment. The non-assignment agreement may take the form of a non-assignment clause embodied in the contract or a separate agreement after the contract is made. In China, there are no restrictive contract interpretation rules that attempt to prohibit the assignment. Therefore, as long as an agreement prohibiting assignment does not violate mandatory provisions of the law or the public policy, the agreement should be held valid and enforceable. In general, a contract provision stating that the contract shall not be assigned, as interpreted in China, would mean a prohibition of both assignment of rights and delegation of duties.[23]

In case where a party breaches the non-assignment agreement, and assigns its rights in the contract to a third party, there is a question about the effectiveness of the assignment if the assignee is a bona fide third party. A widely accepted rule is that the assignee will be found bona fide in the assignment if it had no knowledge about the prohibition of the assignment at the time the assignment was made. But the differences arise as to the consequence of assignment to a bona fide third party by the assignor in violation of non-assignment agreement (or clause).

One opinion is that absent provisions in the Contract Law, the assignment agreement shall only affect the parties, not including a bona fide third party, and then the assignment will be effective to the bona fide assignee regardless of the prohibition of the assignment in the contract. The opposite opinion argues that the provisions in Article 79 of the Contract Law governing the assignment are mandatory, and therefore an assignment shall not be enforced if it violates the parties agreement prohibiting the assignment no matter whether the assignee is a bona fide third party or not.

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[23] In the United States, the non-assignment clause is strictly interpreted. The contract provision prohibiting assignment of the contract is normally construed to prohibit delegation of duties but not assignment of rights. See Rohwer & Schaber, *supra* note 16 at p 363.

Of course, no assignment may be made if prohibited by the law. In China, the contractual rights are non assignable under the law mainly include three kinds of rights. The first is the right that is dependent on personal status or relation, such as family relation. A typical right that bears personal status and is therefore not assignable is the right of claim for alimony, child support, or maintenance.[24] The second type of non-assignable right under the law is the right created and protected by the public law for public policy concern. The right as such includes the right to claim pension fund (for disabled as well survivors), retirement fund, and labor insurance payment. The third right that is statutorily not assignable is the civil law claim right. The most common civil law claim is the tort claim. It is prohibited to assign the right of the claim for the award arising from personal injury and dignitary damages.

2.1.3. *Effect of Assignment*

Under the Contract Law, the effect of assignment may involve two parts. The first part concerns the relation between the assignor and the assignee as a result of assignment, and the second part goes to the change between the assignor (obligee) and the obligor, and between the assignee and the obligor. In general, the assignment will make the assignee the new obligee (whole assignment) or co-obligee (partial assignment) of the contract. After a valid assignment, the assignee will take the place in part or in whole of the assignor, and enjoy the contractual rights accordingly.

With regard to the relation between the assignor and assignee, an important part is the right subordinate to the contractual rights that are assigned, including security interest, accrued interest, claim for stipulated damage and the claim for remedies arising from the contract. The subordinate right itself is not assignable independently, but would be transferred to the assignee with the assignment of contract. As a common principle, the subordinate right shall be automatically, without specific indication, transferred to the assignee along with the assignment of the contractual rights because the subordinate right is attached to, and would affect the realization of, the contractual rights (e.g. the right to receive the performance of the contract).

The Contract Law has a provision relating to the transfer of the subordinate right. Article 81 provides that if the obligee assigns its rights, the assignee

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[24] In China, alimony refers to the mutual support between wife and husband, and the maintenance concerns the supports provided by adult children to their parents (old parents in particular). Under Chinese law, children have the obligation to support their parents. For example, Article 49 of 1982 Chinese Constitution (as amended 2004) explicitly states that parents have the obligation to raise and educate their children who are minors and adult children are obligated to support and assist their parents.

shall acquire the subordinate right in relation to the contractual rights, except that the subordinate right exclusively belongs to the obligee.[25] If the subordinate right is inalienable from the obligee, it is deemed personal and therefore is not assignable. For example, based on the prior dealings, the obligor granted the obligee some benefits (e.g. special status or privilege) as a token to appreciate the obligee's business. The right to claim such benefits may not be assigned with the contract because it exclusively belongs to the obligee.

Also in China, scholars are concerned about assignment of the right to dissolve the contract. Many believe that the right of dissolution of the contract is too personal to be assignable because the right of dissolution concerns fate of the contract, and may not be separated from the obligee.[26] But this concern may not be relevant in a full assignment because by the assignment of the whole contract from the assignor, the assignee would acquire all rights contained in the contract, both primary and subordinate rights (unless prohibited by the law). Under this situation, the right of dissolution of the contract may also be transferred to the assignee along with the assignment.

The effect of the assignment as between the assignor and assignee also imposes the implied duties on the assignor to guarantee that the rights assigned are free from any claims. If there exist defects in the assigned rights, which cause damages to the assignee, the assignor shall be held liable unless the assignee knew the defects at the time of assignment. In addition, the assignor has the obligation to provide the assignee with all documents necessary to prove the assigned rights. Furthermore, it is the assignor's duty to notify the obligor of the assignment in order to effectuate the assignment.

The change between the assignor and obligor, and between the assignee and obligor mainly involves the obligor's performance of the contract. After the assignment, the obligor shall be responsible for the performance to the assignee, and the assignor may not have the right to demand the performance if the assignment is made in full. On the other hand, the obligor shall perform the contract to the assignee. And the contract will not be deemed as being performed if the performance is made to the assignor after the assignment (except for the partial assignment). The assignor may be liable for unjust enrichment if it continues accepting the obligor's performance of the contract that has been assigned.

2.1.4. *Right of Defense in Assignment*

After the assignment, the right of defense that the obligor has against the assignor remains active, but such right may be exercised against the assignee.

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[25] See the Contract Law, art. 81.

[26] See Wang Liming & Cui Jianyuan, *supra* note 15 at p. 423.

According to Article 82 of the Contract Law, after the obligor receives the notice of assignment of contractual rights, the obligor may assert its defense against assignee as it has against the assignor. The purpose is to protect the obligor's rights from being damaged as a result of the assignment. If, however, the obligee assigns all of its contractual rights to the assignee, the obligor's defense based on the contract may only be asserted against the assignee.

In addition, the obligor may acquire independent right of defense against the assignee after the assignment is made. One example is that the obligor may refuse to perform the contract if the assignee's laches in exercising the contractual rights cause the elapse of the statute of limitation. Another example relates to the right to dissolve the contract. If the dissolution of the contract is based on the agreed conditions, the obligor may dissolve the contract against the assignee when the conditions are met.

Under the Contract Law, the obligor may also offset with the assignee the creditor's right that the obligor has against the assignor. The right to offset is particularly granted to obligor in Article 83 of the Contract Law. When the obligor receives the notice of the assignment of the contractual rights, if it has the creditor's right against the assignor, and the rights as such are due prior to the assignment of the contractual rights or at the same time as the assignment is made, the obligor may offset its creditor's rights with the contractual rights assigned to the assignee. To illustrate, assume that A and B have a contract under which B is obligated to pay A, and in the meantime A owes money to C, which is due. When A assigns to C his right to the payment by B, A may offset his debts to C to the amount C is to be paid by B.

The exercise of the right of offset would have to meet certain conditions. First, there must be a bilateral contract in which the obligee and obligor have mutually contractual rights. In other words the parties are both obligee and obligor to each other. Second, the mutual contractual rights are offsetable, which means that the offset could be made by the same or similar kind of thing or by money payment, and is not prohibited by the law. Third, the contractual rights that are used to offset the other contractual rights must become due prior to or at the time of the assignment. The reason is that to offset the contractual rights that are not due would require an advance performance, which may harm the interests of the affected obligor.

2.2. Delegation of Contractual Obligations

Unlike the assignment that generally means the transfer of the contractual rights, the delegation is to transfer the contractual obligations to a third party or to change the obligor. In the United States, after a valid assignment, the assignor ordinarily no longer has any interest in the right that has been assigned, but when an obligation is delegated, the delegating party may continue to

remain liable. Thus the delegation does not free the obligor from the contractual obligations unless there is a novation. In China, however, the delegation may mean to take the contractual obligations off the shoulder of the delegating party. Also one should note that there is no such concept as novation in the Chinese contract law.

Generally, delegation is defined in China as transfer of debt obligations under the contract from the obligor to a third party without affecting the original contents of the obligations. But as a factual pattern, the delegation may take the form of assumption of the debts or substitute of the obligor to perform. The assumption of the debts means a transfer of debts by the agreement among obligee, obligor and the third party, and the transfer may be made in whole or in part. Substitute of obligor refers to the situation where the third party offers to take the place of the obligor to perform the contract duty without an agreement for the debts transfer. Nevertheless, in the context of the Contract Law, delegation denotes a transfer of debts by agreement.

2.2.1. *Delegation as a Transfer of Debts in Whole or in Part*

The Contract Law allows a transfer of debts. Article 84 provides that if the obligor delegates, in whole or in part, its obligations to a third party, it shall obtain consent from the obligee. A logical interpretation of Article 84 tells that the obligor may delegate its obligations if (a) there exist valid contractual obligations, (b) the obligor and the third party agree to the delegation, (c) the obligee makes no objection to the delegation, and (4) the obligations are delegable.[27] The most important element for the delegation under the Contract Law is the obligee's consent. It is also the prerequisite for the delegation to be effective.[28]

Keep in mind that there is a sharp deference in Chinese contract law between a delegation in whole and a delegation in part. The delegation in whole is deemed as a complete transfer of the contractual obligations from the obligor to the third party, whereby the obligor is "exempted" from its contractual obligations and is replaced by the third party. From this point of view, the delegation in whole has the same effect of the novation – a concept used in the American contract law to mean that the existing contract between the obligee and obligor is replaced by a new contract between the obligee and the third party to the extent of the contractual obligations to be performed.

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[27] See the Contract Law, art. 84.

[28] Article 84 of the Contract Law is derived from Article 91 of the 1986 Civil Code that permits a delegation of contractual obligation in whole or in part by agreement. But Article 84 substantially alters Article 91 by deleting Article 91 prohibition that the delegation is made for profits.

A partial delegation is defined as co-assumption of debts. In China, once the obligor delegates some of its contractual obligations to a third party, the obligor and the third party will become jointly responsible for the performance of the contract. However, there is a debate on the relation between the obligor and the third party arising from a partial delegation though it is believed that the obligor remains obligated to perform the contract. One argument is that the partial delegation is simply to add the third party as a new obligor, and the obligor and the third party each bear their own part of the obligations respectively,[29] and no party is responsible for the part of the obligations that the other party should perform. Others contend that the partial delegation will not take the contractual obligations away from the obligor, but rather it makes both the obligor and the third party jointly and severally liable for the contract. Then, after the partial delegation, the obligee may ask either the obligor or the third party for a full performance.[30]

With regard to the consent of the obligee in the delegation of contractual obligations, there are no formality requirements in the Contract Law. It is generally understood that the consent may be made in writing or orally, and it may also be implied from the conduct of the obligee. In addition, as mandated by Article 87, if approval or registration is required for delegation, no delegation shall be made without the approval or registration. The case below stated the situation where the conduct of the obligee was viewed by the people's court as an implied consent to the delegation.

China Great Wall Assets Management Co. (Zheng Zhou)
vs.
Luo Yang Chaoli Lubricate Oil Company, Inc.

The High People's Court of Henan Province[31]

Appellant (Plaintiff at trial) is Zhenzhou Branch of China Great Wall Assets Management Co., Inc.; Appellee (Defendant at trial) is Chaoli Lubricate Oil Company, Ltd. in Luo Yang City. On November 23, 2001, plaintiff brought a lawsuit against defendant at Luo Yang Intermediate People's Court, asking the Intermediate People's Court to order defendant (a) repay the principal of loan in the amount of RMB 1 million and the interests up to the date of repayment, and (b) bear all litigation costs that incur in the lawsuit.

At the trial, the trial court found the following facts: on November 14, 1995 and January 5, 1996, Luoyang Lubricate Oil Factory (the defendant's former name, hereinafter referred to as Oil Factory) mortgaged all of its asserts to obtain two loans from Luoyang Jianxi Branch of China Agricultural Bank (Bank) in the amount of RMB 1 million (RMB 500,000 each). Under the loan agreements, the term of each loan is half year with a

[29] See Yang Lixin, *supra* note 13 at p. 160.
[30] See Dong Ling, *supra* note 4 at p. 149.
[31] See the Civil Judgment of the High People's Court of Henan, (2003) Yu Fa Min 2 Zhi No. 146.

monthly interest rate at 10.08 ‰, and if the borrower defaults its repayment of the loan when due, an additional interest at 0.6 ‰ per day will be charged to any unpaid amount. After the agreements were signed, the Bank transferred the agreed amount of fund into the Oil Factory. But the Oil Factory failed to repay the principal and interests.

On June 7, 2000, the Bank transferred its creditor right against the Oil Factory to plaintiff, and on the same day, a notice indicating the transfer was sent to the Oil Factory. In the notice, it read: " The debts owned as of today were: RMB 1 million in principal and RMB 85,614 in interests. Since all of the loans and interests was past due, please responsively make a full payment for the loans and interests to China Great Wall Assets Management Co, or make an effective payment plan upon receipt of this notice". The receipt of the notice was acknowledged by the Oil Factory with the signature of the Oil Factory's legal representative as well as the Oil Factory's official seal on the return stub of the notice (also called debts confirmation notice).

On July 27, 1999, the Oil Factory held a general assembly of all workers, and a resolution was passed to the follow effects: (a) the factory was to be restructured as a limited liability company, and its name was to be changed to Chaoli Lubricate Oil Company, Ltd. (Chaoli); (b) after the restructuring, all of the legal rights and liabilities including creditor rights and the debts of the Oil Factory was to be transferred to Chaoli; (c) based on the assets assessment conducted by He Nan Provincial Assets Appraisal Firm, the debts/assets ratio of the Oil Factory was 110.27%. After the transfer, new capital was to be added and Chaoli would have a registered capital of RMB 1 million, of which Chaoli Commodities Company owned RMB 800,000, and Luoyang Chaoyuan Industrial Company Ltd. owned RMB 200,000; and (d) the new company's address would be 41 Construction Road, Jianxi District, Luoyang City.

On August 18, 1999, Chaoli Commodities Company and the Oil Factory signed the Agreement of Merger of Luoyang Lubricate Oil Factory into Chaoli Commodities Company". Under the Agreement, the parties agreed that: (a) the Oil Factory was voluntarily acquired by Chaoli Commodities Company, and Chaoli Commodities Company accepted all assets and workers of the Oil Factory and assumed all credits and debts of the Oil Factory; (b) after the acquisition, the Oil Factory shall transfer to Chaoli Commodities Company all of its asserts including land, buildings, machines and equipment; (c) after the appraisal, the Oil Factory was certified to have the total assets of RMB 4.2971 million and total debts RMB 4.7386 million, and the Oil Factory's total net assets were RMB minus 441,500, and its debts ratio is 110.27%. Therefore, the acquisition is zero asset acquisition with debts burden.

The parties further agreed that: (a) after the acquisition, the legal person status of the Oil Factory shall no longer exist, and the employees' collective ownership status shall remain unchanged, and Chaili Commodities Company shall use the name of the Oil Factory free of charge and the name would be changed to "He Nan Chaoli Commodities Company Luoyang City Lubricate Oil Factory", but the business / operation structure of the factory was changed into a limited liability company; (b) Chaoli Commodities Company shall invest capital to form "Henan Luoyang Chaoli Lubricate Oil Company, Inc.", which would become an independent entity of legal person within one year after this Agreement; and (c) the newly formed Chaoli shall be managed in the way Chaoli Commodities Company would manage its subsidiaries.

It was also found in the trial that (a) the Certificate of Change of Registered Name issued to Luoyang Lubricate Oil Factory on November 18, 1999 stated "the name of the enterprise is changed from "Luoyang Lubricate Oil Factory" to "Chaoli Lubricate Oil Company, Inc." On the same day, Chaoli Lubricate Oil Company, Inc. filed with the commerce and industry authority the application for registration, and on November 29, 1999,

Chaoli Lubricate Oil Company, Inc. was authorized to be formed; (b) on December 17, 1999, Chaili Lubricate Oil Company held its inauguration ceremony, and the Bank as creditor sent a representative to attend the ceremony.

During the trial, defendant admitted the debts that were owed to plaintiff, but argued that plaintiff's claim was barred by the statute of limitation because plaintiff did not assert its claim within the time period allowed by the law. Plaintiff rebutted that it (including the Bank) had no knowledge about the acquisition and the Oil Factory did not notify creditors of its being acquired by Chaoli Commodities Company. Plaintiff also argued that on June 7, 2000, when the Bank transferred its creditor right to the Great Wall Assets Management Company, the Oil Factory was given a notice of the transfer and Oil Factory also signed the notice, therefore the statute of limitation was not an issue because June 7, 2000 should be the starting date to count the four year limitation.

The trial court held that the loan agreement between the Bank and Oil Factory was valid. The trial court also held that the transfer of the debts through acquisition from the Oil Factory to defendant should be regarded as valid in consideration of the fact that the Bank attended the opening ceremony of the Chaoli Lubricate Oil Company, Inc., which evidenced the plaintiff's knowledge about the acquisition. The issue then was whether the statute of limitation would bar plaintiff from making the claim. The trial court denied plaintiff's argument about June 7, 2000 notice. According to the trial court, defendant was formed on November 29, 1999 and inaugurated on December 17, 1999. When the Bank transferred its creditor right to the Great Wall Assets Management Company and dispatched debts confirmation notice to the debtor on June 7, 2000, such a notice should be sent to defendant, not the Oil Factory since after November 29, 1999, the Oil Company as a legal person ceased to exist. For this reason, the trial court dismissed the idea that the June 7, 2000 notice would serve to halt the running of the statute of limitation.

In its decision, the trial court concluded that plaintiff in this case had lost its right to make any claim against defendant because the time period between the agreed repayment date and the date of this litigation is beyond the limit imposed by the statute of limitation set forth in the 1986 Civil Code and plaintiff failed to prove the existence of any situation in which the statute of limitation has been suspended.[32] The trial court then ordered that (1) plaintiff's claims be dismissed, and (2) plaintiff pay the litigation fees of RMB 15,345 as well other related fees of RMB 3,087. Plaintiff appealed.

On appeal, plaintiff argued that trial court was wrong in finding non-existence of the Oil Factory after the registration of defendant because the registration only indicated the chance of name of the entity, and did not extinguish the entity. Plaintiff further argued that if the acquisition would cause the Oil Factory to be extinguished, defendant was obligated to send a notice to plaintiff, and even if the Bank had representative to attend defendant's

[32] Article 135 of the 1986 Civil Code provides that except as otherwise provided by law, the limitation of action concerning claim to the people's court for protection of civil rights shall be two years. According to Article 136, the limitation of action shall be one year in the following cases: (a) claim for compensation for bodily injuries, (b) sales of substandard goods without proper notice, (c) delays in paying rent or refusal to pay rent, or (d) loss of or damage to property left in the care of another person. Under Article 137, the limitation of action is calculated from the date when the entitled person knows or should know that his rights have been infringed upon. (Footnote added).

opening ceremony, it did not mean that defendant had fulfilled its notice obligation. Plaintiff also argued that since debts confirmation notice was signed by both the Oil Factory and its legal representative and in the acquisition agreement the Oil Factory agreed to allow defendant to use all assets of the Oil Factory without charge, the signature shall be deemed to bind defendant, which also indicated that plaintiff had made claim for which the statute of limitation shall be interrupted.

To rebut, defendant asserted that when the Great Wall Assets Management Company assigned its creditor rights to plaintiff, it did not notified defendant of the assignment, and the assignment therefore was not effective to defendant. Defendant insisted that defendant's registration as a limited liability company was not simply a change of the name of entity, the registration indicates a birth of a new company, and for this reason, after the registration, the Oil Factory did not exist any more. Defendant also argued that the Bank had full knowledge of the acquisition by attending defendant's inauguration, and there was no requirement that an acquisition be made public by a public notice in media.

Having reviewed the facts in this case and heard the arguments from both parties, we hold that defendant company was established by absorbing all assets and liabilities of the Oil Factory, and by investing new capital into the newly established entity, and as a result, defendant company shall be deemed as a new company, not the original entity with a changed name. It is our opinion that the acquisition process indeed had defect because it failed to notify the creditor in writing. However, the Bank's attendance in defendant's opening ceremony was a clear indication of the Bank's knowledge of the acquisition and the delegation of the debts, which would cure the defect with regard to the notice.

What really matters in this case is the debts confirmation notice. The undisputable facts reveal that at the time when the Bank assigned its creditor right against defendant to plaintiff, the Oil Factory was already acquired by defendant, and the Bank should send notice to defendant. Unfortunately, however, the Bank had the notice sent to the Oil Factory and its former legal representative, and obtained signatures from them on the notice. Although the former legal representative of the Oil Factory worked for defendant at the time of signature, he was not an authorized officer of the defendant. Therefore, it is reasonable to conclude that the Bank made mistake and sent the debts confirmation notice to a wrong person, which would necessarily result in an ineffective assignment of the creditor rights to the Great Wall Assets Management Company as far as defendant is concerned because defendant was not notified of the assignment.

Since there is no effective assignment of the creditor right against defendant, plaintiff has no valid standing in making its claims, and the appeal then must be denied. The trial court judgment then is affirmed, and the litigation fees of RMB 20,010 on appeal are to be paid by plaintiff.

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In *China Great Wall Assets Management*, the trial court entered a judgment in favor of defendant on the round of statute of limitation and the appellate court affirmed the trail court judgment on the different ground, namely plaintiff's lack of standing to bring the lawsuit. What is relevant to out discussion, however, is the court's holding both at trial and on appeal that the consent of an obligee to the delegation of obligation could be inferred from the certain conduct of the obligee. In this case, sending a representative to attend the opening ceremony constituted a factual consent to the delegation of obligation.

2.2.2. *Subordinate Duties*

When obligor delegates it contractual obligation to a third party, the duties necessarily attached to the contractual obligation shall be transferred along with the delegation. The duties that are deemed subordinate to the contractual obligations (the principal obligations of the contract) include the duty to pay interests, the duty to pay stipulated damage or earnest money for breach of the contract, and the duty arising from the guarantee that the obligor provided to ensure the performance of the contract. Since the subordinate duties normally have significant impacts on the contract performance, it is natural to require that they should automatically be assumed by the third party (delegate) in a valid delegation of contractual obligations.

Realizing the importance of the subordinate duties in the delegation, the Contract Law contains a special provision requiring the transfer of such duties. Under Article 86 of the Contract Law, if the obligor delegates its obligations to a third party (who then becomes a new obligor), the new obligor shall assume the subordinate duties relating to the principal obligation of the contract, excluding the duties that are exclusively personal to the obligor.[33] The exclusively personal duties mostly involve those arising in personal service. For example, if the parties agree that the obligor may paint a portrait for the obligee as a payment for the interests accrued from the contractual obligation, the duty to paint the portrait will be regarded personal exclusively to the obligor, which may not be delegated.

If, however, the contract performance is under the guarantee provided by a third party guarantor, the duty of guarantee will not be included in the delegation unless the guarantor expressly agree to the continuance of the guarantee after the delegation, or otherwise the guarantee will end with delegation. According to Article 23 of the Guaranty Law of China, if during the term of guaraneey, the obligee allows the obligor to delegate the duties, the consent in writing from the guarantor must be obtained in order for the said guarantee to continue operative. Thus, if the duties are delegated without the guarantor's consent, the guarantor will no longer be responsible for the guarantee.

2.2.3. *None-Delegable Duties*

The Contract Law, in its General Provisions, imposes no restrictions on the delegability of contractual obligations. Generally speaking, therefore, as long as the obligee agrees, all contractual obligations are delegable unless the obligations may not be delegated either because of the nature of the debts or under

[33] See the Contract Law, art. 86.

the provisions of law. If the contract contains a provision that explicitly prohibits delegation of obligation, no delegation shall be made unless otherwise agreed by the obligee.[34]

In the Special Provisions of the Contract Law, there are certain obligations that are prohibited from being delegated to a third party. For example, under Article 272 of the Contract Law concerning construction contracts, the general contractor for a construction project is prohibited from delegating its duty to any sub-contractor on the construction of mainframe of the project.[35] In addition, the obligations that are normally deemed personal, such as obligation for child support or alimony, are also not delegable. Moreover, the obligor may not delegate to anyone his or her obligation arising from civil liabilities imposed by the operation of law, such as rehabilitation of other's reputation, elimination of ill effects, and apology to others.

2.2.4. *Transfer of Obligor's Right of Defense Against Obligee*

When obligator delegates its obligations to a third party, any defense that the obligor has against the obligee is transferred to the third party. Consequently, the third party may exercise the defense to the extent that the obligor is entitled to make. A rule provided in Article 85 of the Contract Law is that if the obligor delegates its obligations to third party, the new obligor may have the defense that the original obligor would have against the obligee.[36] Note, however, that in order to effectuate such transfer, the right of defense that belongs to the obligee in relation to the delegated obligations must accrue before the delegation is made. In other words, the delegate may not assert any defense that the obligor may have or acquire after the delegation is made.

Transfer of the obligor's defense right also depends on the validity of the delegation. If the delegation is invalid or has not taken effect, the obligor's defense right may not be transferred. For instance, the obligor may delegate all of its contractual obligations, but the delegation is subject to the consent of the

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[34] In U.S., a contract provisions prohibiting delegation will most likely not be interpreted to prohibit the delegation of a duty that is totally impersonal such as the duty to pay money (see, Rohwer & Schaber, Contracts in A Nut Shell, *supra* note 16 at p. 381). In China, however, no distinction in this regard is made. But in practice, if a pure money payment is involved, a delegation to make such payment to the obligee may be recognized in case where the delegation is prohibited by the contract. In this situation, however, the delegated third party may under no obligation make such a payment because of the questionable effect of the delegation.

[35] See the Contract Law, art. 272.

[36] See *id*., art. 85.

obligee. Therefore, the transfer of the obligor's defense right will not take effect unless the obligee agrees to the delegation of the contractual obligations.

2.3. Comprehensive Assignment

In China, a comprehensive assignment occurs when there are both assignment of the contractual rights and delegation of the contractual obligations with regard to a particular contract. Under the Contract Law, the comprehensive assignment is to be governed by the provisions related to assignment and delegation. According to Article 88 of the Contract Law, the party to a contract may assign its rights and obligations together under the contract to a third party with the consent of the other party.[37] Accordingly then, a comprehensive assignment of the contract is permissible, but the consent of the other party is required.

A comprehensive assignment may be made by agreement. In order to make an assignment as such, there are at least two agreements that must be made. One is the agreement between the original parties of the contract to the effect that a party's request for the assignment of all of its rights and obligations under the contract to a third party is agreed by the other party to the contract. The other one is the agreement that is entered between the assignor and assignee, under which the assignee agrees to take over the rights the assignor has under the contract, and in the meantime to assume all obligations that the assignor is required to perform.

Under the Contract Law, for a comprehensive assignment to be valid, four elements are required. First, there must be a valid contract and such a contract must also be a bilateral one. If the contract is unilateral, there may only be either assignment of rights or delegation of obligations. Second, a mutual agreement is made between the assignor and assignee to the effect of the assignment. Third, an express consent must be obtained from the other party to the contract. And forth, there must be no violation of law with regard to the assignment, which means that the contract must be assignable and the obligations must also be delegable.

On its face, the comprehensive assignment may look similar to the novation in American contract law. They are similar because they all involve a change of the party to the contract. The major difference between the comprehensive assignment and novation perhaps is that in novation, an agreement between the existing original party and the assignee is required, but no such requirement is needed for the comprehensive assignment. To put differently,

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[37] See *id*., art. 88.

the novation may not occur without mutual assent of all three parties because the result of novation is that one of the original parties to the contract is removed from the transaction and the newcomer is substituted in his place.[38] Thus in novation, there will be a new contract between an original party to the contract and the newcomer (third party). Clearly, the comprehensive assignment under the Contract Law does not result in a new contract.

In China, a comprehensive assignment may also occur under the requirements of law. Such an assignment normally takes place in the situation where there is a merger or acquisition that affect the parties to the contract. Article 90 of the Contract Law requires that if one party to a contract is merged after the contract, the legal person or organization established after the merger shall exercise the contractual rights and perform the contractual obligations. Article 90 also makes it clear that if one party to the contract is separated after the contract is made, the legal persons or organizations thus established after the separation shall exercise the contractual rights and assume the contractual obligations jointly and severally.[39]

The provision of Article 90 seems hard to read. What it actually means is essentially that if there is a merger, acquisition, or separation of business, the newly established or organized business entity shall remain liable for the contract that is made by its predecessor. Particularly in case of separation of business, a joint liability will be imposed upon the business entities that are born as a result of the separation. The purpose is to maintain the stability of the business transactions and the continuity of existing contractual rights and obligations. Certainly, it will also help ensure that the contract will be performed and nobody may evade its contractual obligations through the change of business structure.

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[38] See Rohwer & Schaber, *supra* note 16 at p. 398.

[39] See the Contract Law, art. 90.

Chapter IX
Dissolution and Termination of Contracts

As a general principle under the Contract Law, a contract, once legally formed, must be performed. The strict performance requirement is also underscored, at least in theory, by the traditional virtue of promise honoring. The performance, however, may be excused upon the occurrence of certain events prescribed by the law. The direct result of the excuse for the non-performance is the dissolution of the contract, under which the party's obligation to perform is discharged. Generally, the contract dissolution is defined in China to mean extinguishment of contractual relationship between the parties by the manifestation of the intent of one or both parties as a consequence of the occurrence of the legally prescribed events.

Scholars in China debate on the difference between dissolution of the contract and termination of the contract. One argument is that dissolution and termination are the same, and the dissolution in essence is referred to as advance termination of the contract by agreement of the parties or by operation of law. Therefore, if the contract is dissolved by the parties' agreement or pursuant to the provision of law, the contract is terminated. In the sense in which the contract is discharged, there is no difference between dissolution and termination.

The opposite opinion, however, regards the dissolution as one of the elements for termination of the contract. In this opinion, dissolution differs from termination in several aspects. First, the dissolution may be followed by restitution in order to avoid unjust enrichment, but the termination may end up with the discharge of the contract. Second, the dissolution may retroactively affect the past rights and obligations of the contract, while termination only

deals with the present and future effect of the contract – i.e. it simply extinguishes the contractual relationship. Third, dissolution is often used as a means to punish the party in breach (e.g. the aggrieved party is given the right to dissolve the contract). The termination, however, is mainly used in the situations where there may not be a breach of contract.[1]

The Contract Law seemingly takes the stance to treat the dissolution as one of the circumstances under which a contract may be terminated. For example, in Article 91 of the Contract Law, there are seven situations that would cause to terminate a contract, one of which is dissolution. On the other hand, however, the Contract Law is not intended to make distinction between dissolution and termination. Loosely speaking, the dissolution mainly deals with the excuses for which a duty to perform a contract may be discharged without triggering to liability for breach of the contract. In China, there has been a suggestion that a buzzword "retroactive" be used to help tell dissolution from termination in general. If the discharge of the contractual obligations has a retroactive effect on the contract (e.g. restitution), the discharge is normally a dissolution. Otherwise, the discharge would mean a termination.

1. Dissolution

A contract may be dissolved under certain circumstances, and the occurrence of a circumstance that leads to dissolution of a contract would serve as an excuse for the party involved not to perform its contractual obligations. As indicated above, under the Contract Law, a contract may be dissolved either by an agreement or by provision of law. In either case, the dissolution will result in the discharge of the contract, and thus, none of the parties, upon the dissolution of a contract, may have the right to ask the other to continue performing the contract.

1.1. Dissolution by Agreement

Premised on the principle of freedom of contract, the parties to a contract may decide to dissolve the contract as they wish. The Contract Law not only recognizes the right to dissolve, but also allows the right to be exercised in two different ways: (a) dissolution agreement and (b) agreed conditions. Article 93 of the Contract Law provides that a contract may be dissolved upon a consensus of the parties through negotiations. Article 93 further provides that the parties to a contract may agree upon the conditions to dissolve the contract by

[1] See Wang Liming, *Study on Contract Law (Vol. II)*, 273 (People's University Press, 2003).

one party, and then if such conditions are met, the party entitled to dissolve the contract may exercise its right to have the contract dissolved.[2]

Dissolution agreement refers a consensual conduct of the parties as a result of negotiation to bring their contract relationship to an end after the contract is concluded, but before the contract is performed or before the performance is complete. Thus the dissolution agreement has three distinctions. First, it is an agreement that is aimed at ending the existing contractual relationship. Second, the agreement is made after the conclusion of the contract but before the performance or completion of the performance. Third, the agreement must be made voluntarily and reflect the true intention of the parties. If, however, the dissolution agreement is found to be made against the will of a party or in violation of law, the agreement will be null and void, and then the parties remain responsible for the performance of the existing contract.

The immediate effect of a valid dissolution agreement is the extinguishment of the contract by which the parties are currently bound. The parties, of course, may, in the dissolution agreement, set forth a date on which their contractual relationship ceases to exist. There are two issues that may necessarily be raised in the dissolution by agreement. One issue is the restitution that deals with the benefits one party has already conferred upon the other. Without restitution, the benefited party would apparently unjustly enriched. The second issue is the damage that one party has caused to the other in case of dissolution. The issue of damage is actually the matter of compensation to which the aggrieved party is entitled as a result of the other party's breach of the contract.

These two issues become relevant only when the parties could not reach a consensus on the matter of restitution or compensation in their negotiation for dissolution. Under Article 97 of the Contract Law, in case of dissolution, if the contract has been performed, a party to the contract may, in light of the performance and the character of the contract, request for restitution or take other remedial measures. Article 97 also provides the aggrieved party with the right to seek for compensation for the damages.[3]

However, there are different views as to whether Article 97 may apply to the dissolution agreement. One view argues that since the dissolution agreement represents the will of the parties to end the contractual relationship between them, if the parties reach the agreement to dissolve the contract without mentioning restitution or compensation, the parties are deemed to have abandoned the right to make such a claim, or the right of the parties to ask for

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[2] See the Contract Law, art. 93.

[3] See *id*., art. 97.

restitution or compensation is regarded as having been waived. Another view takes an opposite opinion that the dissolution agreement shall not affect a party's right to claim for restitution or compensation, and the right shall not be deemed as waived if it is not mentioned in the dissolution agreement unless the claiming party specifically gives it up.[4]

In between the above two is the moderate approach. This approach, attempting to narrow down the difference between the two opposite views, advocates a focus on the actual will of the parties. According to the moderate approach, in a dissolution agreement, the intent of the parties with regard to restitution or compensation should be expressly stated. If the issue of restitution or compensation was never raised in the negotiation for the dissolution agreement, the right to make such a claim is deemed as waived. If, however, the parties had discussed this issue in their dissolution negotiation but failed to reach an agreement in this regard, no claim shall be considered as being waived or abandoned.[5]

Agreed conditions involve the events agreed upon by the parties in a contract, and occurrence of which would enable a party to dissolve the contract. Based on Article 93 of the Contract Law, the major distinction of the agreed conditions is that the agreed conditions are contractually provided, and are purposed to give a party the right to end the contract upon satisfaction of the conditions provided by the parties. Note that agreed conditions are the events that may happen in the future. For example, in a contract for a month-long entertainment performance, the parties may provide that if the income from box office is less than $30,000 for the first three nights, party A may at its own option dissolve the contract with party B (performer). Then the "box office income less than $30,000 for the first three nights" (which may happen) is the agreed condition for dissolution of the contract.

As we have discussed in Chapter VII, there is a concept of dissolving condition in Chinese contract law theory. If a contract contains a dissolving condition, the occurrence of the condition will necessarily terminate the contract. The common character of dissolving condition and agreed condition is that both are provided in the contract and are the agreed events that may affect the effectiveness of the contract. They, however, differ from each other in that the dissolving condition deals with automatic dissolution of the contract upon the occurrence of the condition, but the agreed condition may affect the contract only if the party having the right to dissolve chooses to exercise the right. To illustrate, in the above performance example, if the contract provides instead that the contract will cease effect if the first three-night income is less than $30,000, the box office income "less than $30,000 in the first three nights"

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[4] See Wang Liming, *Study on Contract Law (Vol. II), supra* note 1 at 279–280.

[5] See *id*.

would be the dissolving condition. In this situation, the contract will be terminated automatically without any party's initiative.

1.2. Dissolution by Provision of Law

Absent agreement by the parties, a contract may also be dissolved if certain event as provided by the law occurs. Dissolution by operation of law takes place in the case where the law allows a party to choose to dissolve a contract when certain conditions are met, and under this circumstance the right to dissolve the contract is exercised without obtaining the consent from the other party. The purpose is to provide a party with the statutory right to protect its interest by self-determining whether to continue performing the contract.

The Contract Law provides five conditions under which a contract may be dissolved unilaterally. Pursuant to Article 94 of the Contract Law, in any of the following circumstances, a party may have the contract dissolved: (a) the purpose of the contract could not be realized due to *force majeure*, (b) one party to the contract, before the expiry of the performance period, explicitly expresses or indicates through its conduct that it will not perform the principal obligations, (c) one party to a contract defaults in performing the principal obligations under the contract, and after being urged, fails to perform the said obligations within a reasonable period of time, (d) one party to the contract defaults in performing its contractual obligations or commits other acts in breach of contract so that the purpose of the contract could not be realized, or (e) other situation as stipulated by law.[6]

In fact, Article 94 states only three types of statutory dissolution of a contract: dissolution due to *force majeure*, dissolution on the basis of breach of contract, and dissolution by other statutory reasons.[7] Because the Contract Law provides dissolution both by agreement and by provision of law, a question then is whether the dissolutions under the two grounds are mutually exclusive. The general view is that the contractual dissolution and the statutory dissolution could co-exist under the Contract Law because the contractual dissolution may be used to supplement the statutory dissolution. A related question then is whether the contractual dissolution may alter or limit the right to dissolve the contract under the provision of law. Some argue that since Article 94 is not a mandatory provision, the parties' agreement may supersede the statutory provision in terms of dissolving a contract.[8]

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[6] See the Contract Law, art. 94.

[7] See Dong Ling, *Performance, Modification, Assignment and Termination of Contracts*, 190 (China Legal System Publishing House, 1999).

[8] See Wang Liming, *supra* note 1 at p. 283.

1.2.1. *Force Majeure as the Ground for Dissolution*

Force majeure is defined in Article 117 of the Contract law to mean the objective circumstances that are unforeseeable, unavoidable and insurmountable.[9] Such objective circumstances include natural disasters (such as fire, flood, earthquake, and the like), and social or political changes (e.g. social turmoil, strike). In addition, the change of law is also regarded as the objective circumstance for the purpose of dissolving a contract. For instance, if a contract becomes invalid under a newly adopted law, the new law would be the cause to the dissolution of the contract since the adoption of the new law would make it impossible to continue performing the contract.

Force majeure may affect the performance of a contract in different way in terms of scale and scope. Generally speaking, *force majeure* may lead three different results in terms of contract performance, and they are: impossible to perform the whole contract, impossible to perform partial contract, or delay in performance. Realizing that *Force majeure* might be improperly asserted, Article 94 of the Contract Law imposes limits on the use of *force majeure* as the ground to dissolve a contract. Under Article 94, only when the *force majeure* is so severe that the purpose of the contract could not be realized, the contract may then be dissolved. Normally the purpose of contract is interpreted to mean the expected interest or benefit of the parties to the contract.

If, however, *force majeure* only makes it impossible to perform partial obligations of a contract, the contract may be modified to the extent that only the obligation of a party to perform the affected part of the contract would be discharged. Of course, the whole contract may be dissolved if the purpose of the contract is frustrated as a result of *force majeure* even though only partial performance is affected. The same situation would also apply to the delay in performance caused by *force majeure.*

What seems unclear is who has the right to dissolve the contract in the case of *force majeure*. To interpret Article 94 literally, both parties would have the right because of Article 94 uses the word "parties" to specify the dissolution right. Logically, for the reason of *force majeure*, the performing party (debtor) would have the lawful excuse not to perform its contractual obligations, and the party receiving the performance (creditor) would have the right to dissolve the contract. But there might be a reasonable inference that if the purpose of contract is destroyed by *force majeure*, either party may have the right to seek dissolution of the contract.

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[9] See the Contract Law, art. 117.

1.2.2. *Dissolution Because of Breach of Contract*

As provided in the Contract Law, if a party is in breach of contract, as a legal remedy, the other party may dissolve the contract. Such a remedy, however, is not available in any breach of contract. It applies only to the breach specified by the law. Article 94 permits the dissolution in three kinds of breaches: anticipatory repudiation, unreasonable delay in performance, and frustration of purpose of contract. If a breach falls within any of these three categories, a party is entitled to the dissolution of the contract.

Anticipatory Repudiation

Anticipatory repudiation is a common law concept that gives a party a legal right not to go forward with the contract performance in the case where the other party denies any intention to perform before the performance of a contract is due.[10] In American contract law, anticipatory repudiation serves as a legal ground under which a party's duty to perform may be excused. In the U.S., in case of anticipatory repudiation, the non-repudiating party may suspend its own performance, bring a lawsuit immediately, rescind the contract or ignore the repudiation and urge performance. In order to constitute anticipatory repudiation, the statement of intent (expressed or implied from conduct) not to perform must be clear and unequivocal.

Article 94 of the Contract Law borrows the concept of anticipatory repudiation from the common law system, and makes it as a legal base for the dissolution of a contract in China. Under Article 94 (b), three elements are required for finding an anticipatory repudiation. The first element is the manifestation of intent not to perform. The manifestation may be made expressly or implied by conduct. Although the word "unequivocal" is not used in Article 94, it is required that manifestation be explicit to the extent that the contractual obligation will not be performed. The second element is expiry of the time period for performance. To constitute an anticipatory repudiation, the intent not to perform must be manifested before the day the performance period expires. The third element is non-performance of principal obligations. The intent not to perform must involve principal obligations of the contract, or otherwise the non-performance would not amount to the anticipatory repudiation.[11]

Thus, despite the fact that Article 94 (b) is modeled after the common law concept, the anticipatory repudiation, as used in China, seems to have two

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[10] See Rohwer & Schaber, *Contracts In A Nut Shell*, 316 (West, 1997).

[11] See the Contract Law, art. 94.

distinctions. One distinction is the time of repudiation (or the time when non-repudiating party's right arises). In the United States, for example, the anticipatory repudiation of a contract occurs when a party repudiates the contract before the time for performance is due.[12] However, Article 94 (b) of the Contract Law sets the time of repudiation as the one that the period of performance expires. Admittedly, the term "expiry of the time period for performance", as used in Article 94(b), may cause confusing because in many cases it is difficult to tell when the performance expires.

Nevertheless, some scholars try to argue that the "expiry of the time period for performance" would mean either the day before the performance is due, or the day after performance is due but before the time for performance expires (in the situation that the due day and expiration day are not on the same day). For instance, assume that the contract provides for a performance between May 1 and May 10. Then May 1 would be the day the performance is due and May 10 the day performance gets expired. If, however, there is clearly no performance period in the contract, the time for performance will be the day when performance becomes due.[13]

Others disagree. They emphasize that anticipatory repudiation is a prospective breach of contract, and such a breach may only happen when it is clear that the performing party will not perform its obligations after the time period for performance ends. The reason is that the performing party has every right not to perform before the expiration day of the performance, and therefore the non-performance before that day does not constitute a breach.[14]

The other distinction between China and common law system in the concept of the anticipatory repudiation is the requirement of principal obligations. The Contract Law attempts to divide the contractual obligations into principal obligations and non-principal obligations, and limits the anticipatory repudiation to only the intent not to perform the principal obligations. But the Contract Law contains no definition as to what obligations are deemed principal. A common understanding is that the obligations are principal if they are the main focus or target of the contract, substantial to the contract or determinative to the nature of the contract, without performing which, the contract would not be performed or the purpose of the contract would not be reached. As a matter of fact, the determination of the principal obligations would vary depending on the contents of particular contract.

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[12] See Calamari & Perillo, *The Law of Contracts* (4th Ed), 477 (West Group, 1998).

[13] See Dong Ling, *supra* note 7 at p. 195.

[14] See Yang Lixin, *Implication and Application of the Contract Law*, 183 (Jilin People's Publishing House, 1999).

Article 94 (b) allows the non-repudiating party to dissolve the contract in case of anticipatory repudiation. Note that under Article 94 (b), the non-repudiating party may dissolve the contract, and the word "may" used here clearly indicates that the exercise of such right is at the non-repudiating party's choice. Therefore, even if there is an anticipatory repudiation, the non-repudiating party may choose to disregard the repudiation, and urge the repudiating party to perform the contract. In addition, the non-repudiating party may regard the repudiation as a breach and bring a lawsuit. The remedy as such is provided in Article 108 of the Contract Law, and will be further discussed in the next chapter.

Unreasonable Delay in Performance

Delay in performance of a contract is understood in China to include two aspects: delay in delivery (including making a payment) or delay by obligor, and delay in acceptance or delay by obligee. Article 94 (c) of the Contract Law deals only with the delay in delivery because it is basically concerned with performance of obligations (while delay in acceptance mainly involves improper cooperation of the obligee with regard to the obligor's performance). Delay in performance occurs when obligor who is able to perform the obligations before the expiry of the performance period fails to perform timely without reasonable cause.

To speak more specifically, delay in performance refers to a situation where the obligor is able to perform (as opposed to impossible to perform) and willing to perform (as opposed to anticipatory repudiation), but without justifiable reason fails to perform after the performance is due. If, however, there is no agreed day or period for the performance of contractual obligations, the obligee may ask obligor to perform any time, but the obligee must give the obligor a reasonable period of time to prepare for the performance. In this case, delay in performance shall be determined by taking into consideration the reasonable preparation period.

Once more, in case of delay in performance, whether the obligee may dissolve the contract is dependent on whether the delay affects the performance of the principal obligations of the contract. Article 94 (c) demands a showing of the delay in performing the principal obligations in order for the obligee to be entitled to the dissolution of the contract. In addition, when there is a delay in performance, the obligee is required to "urge" the obligor to perform. To "urge" means to send a notice of performance to the obligor, and the notice could be made either in writing or orally. After the notice, the obligor shall be allowed to have a reasonable period of time to prepare for the performance. The reasonable period of time would be the time necessarily needed for the preparation according to the nature and customs of the particular transactions.

Thus, to make an Article 94 (c) claim for the dissolution of a contract, the following elements must be presented: (1) delay in performance, (2) of principal

obligations, (3) without justifiable reason, (4) failure to perform, (5) within a reasonable period of time, and (6) after a notice to urge is given. Obviously, the requirement of principal obligations serves a twofold purpose: to assure that the aggrieved party gets what he has bargained for, and to avoid undue hardship on the non-performing party arising from the possible dissolution of the contract.

Frustration of Contract Purpose

Article 94 (d) permits a party to dissolve the contract if the purpose of the contract is frustrated as a result of the other party's delay in performance or other conducts of breach of contract. Apparently, the attention of Article 94 (d) is on the consequences of non-performance of the contract, and it covers two difference causes: delay in performance and other breach of contract conducts. The key issue is whether the purpose of the contract is frustrated or destroyed.

With regard to the delay in performance, Article 94 (d) seems to provide an exception to Article 94 (c) in that the delay in performance itself, without more, would suffice the dissolution of a contract if the delay causes to frustrate the purpose of the contract. To put another way, if the time of performance is critical to the contract and any late performance will render the contract meaningless, the delay will give rise to the right of the aggrieved party to dissolve the contract regardless of principal obligations or notice to urge performance.[15]

Other conducts of breach of contract as the cause to dissolve a contract are problematic because they are not specified in the Contract Law. One interpretation is that any conduct in breach of contract would fall within the coverage of Article 94 (d) if the conduct as such results in the frustration of the purpose of the contract.[16] The other interpretation tried to be a bit more specific by defining "other conducts" to mean the breach of contract conducts other than delay in performance, which includes impossibility, refusal of performance, improper performance, partial performance and the like.[17] But in any case, the determinant is whether the purpose of the contract has been frustrated or destroyed as a result of the breach.

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[15] A similar concept in this regard in the US contract law is the doctrine of "time is the essence of contract". But the difference is that in order to assert this doctrine to hold the other party who delays in performance liable, it must be specified in the contract (i.e. there must be a phrase in the contract. Saying the essence of the time to the contract).

[16] See Dong Ling, *supra* note 7 at pp. 203–204.

[17] See Jiang Ping et al, *A Detailed Explanation of the Contract Law of Law*, 80 (China University of Political Science and Law Press, 1999). See also Wang Liming, *supra* note 1 at pp. 292–294.

Some argue that Article 94 (d) actually infers the situation where there is a fundamental breach – the term most commonly used in western countries. In the United States, the fundamental breach is termed as material breach, which would justify a cancellation of the contract.[18] The opponents, however, view Article 94 (d) as a less restrictive version of the doctrine of fundamental breach. They believe that the fundamental breach is not equivalent to the frustration of the purpose of contract because the frustration under the Contract Law means a failure to achieve the goal or realize the benefits of the contract while the fundamental breach could be caused by many other reasons. In addition, in certain cases, the reasonable prediction of an ordinary person is used as a standard to determine whether the liability of the party in breach may be reduced if a fundamental breach occurs.[19]

1.3. Dissolution for Other Reasons Provided by Law

Article 94 (e) of the Contract Law is a catchall provision under which a contract may be dissolved in other circumstances as stipulated by law. Such provision on the one hand requires a cross-reference to the relevant provision contained in other part of the Contract Law or any other existing laws, and on the other hand leaves certain room for a later legislation. On such example in terms of relevant provision is Article 69 of the Contract Law. Under Article 69, a contract may be dissolved by the aggrieved party if the other party, after the performance is suspended, fails to reinstate its capacity of performance and does not provide assurance for the performance.[20]

But, the question is whether the "law" in this sense would include the lower level regulations, e.g. regulations adopted by the State Council, rules issued

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[18] Generally, a breach is regard as material if, as a result of the breach, the aggrieved party does not receive the substantial benefit of what was bargained for. Although under the Second Restatement, the material breach justifies the suspension of performance, not necessarily cancellation of the contract, the aggrieved party may treat the contract as at an end and has the right to damages for breach of the contract. But if necessary to make a comparison, the delay in performance as provided in Article 93 (c) seems more like a material breach.

[19] This argument is premised on Article 25 of the United Nations Convention on International Sales of Goods. It provides: "a breach of contract committed by one of the parties is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result".

[20] Also other examples in the Contract Law dealing with sales contracts are Articles 148 (defective quality of contracted goods), 165 (defective item among many items), and 167 (failure to pay in installment payments).

by various ministries, ordinances passed by local legislative bodies, or even unpublished government directives. What is clear now, at least officially, is the rule prohibiting the application of any unpublished government directives or orders under China's concession to the WTO. With regard to the lower level regulations, restrictively speaking, they do not fall within the scope of the "law" in the context of the Contract Law because only the statutes promulgated by the National People's Congress are characterized as the "law". But, in practice, the law often tends to be broadly defined to include regulations, rules as well as local ordinances.

A harder issue is whether the change of government policy may fall within the "other reasons" for which a contract may be dissolved. In the following case, defendant attempted to assert the "change of the State policy" as a defense to its termination of the performance of the contract.

Kun Ming Teng Si Lin Trade Company, Ltd
v.
China Unicom, Inc. Yun Nan Branch

Kun Ming City Intermediate People's Court, Yun Nan Province
Kun Min Si Chu Zhi No. 007 [21]

On February 17, 2000, plaintiff Kun Ming Teng Si Lin Trade Company, Ltd and defendant China Unicom, Inc. Yun Nan Branch entered into the "Sales Agreement on Outright Purchase of '130 Teng Si Lin SIM Card' Utilizing China Unicom GSM 130". Under the Agreement, plaintiff would purchase and sell 100,000 China Unicom GSM 130 SIM cards and its number resources. Also, plaintiff was required to deposit "Credit Guarantee Fund" with defendant, and the fund would be refunded in proportion to the fees collected by defendant with regard to the use of the cards, such as basic charge, line subscriber fee, network charge and long distance call charge. In the Agreement, the parties agreed that if the sales of the cards could not continue due to the policy adjustment by the government, defendant should refund to plaintiff the money of all unsold SIM cards at the price charged when plaintiff acquired the cards.

On February 23, 2000, plaintiff transferred to defendant's bank account RMB 1.6 million Yuan, and obtained from defendant 2500 cards. Plaintiff then started selling the cards immediately thereafter. On April 26, 2000, however, defendant sent a letter to plaintiff asking plaintiff to stop selling the cards, and attached to the letter was defendant official document entitled" Emergent Notice Concerning the Unicom's Implementation of the State Policy on Charges and Fees". The document was issued in response to the Ministry of Information Industry's "Notice on Strengthening the Management of Charges and Fees for Cellular Phone Services".

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[21] See the National Judicial College & People's University Law School, *An Overview of the Trial Cases of China* (Volume of Commercial Cases 2004), 32 (People's Court Press and People's University Press, 2005).

Upon receiving defendant's emergent notice, plaintiff stopped all sales of the cards, and the parties managed to count unsold cards and negotiated on the matter of refund. By December 2000, the unsold cards, as counted by the employees of the parties, were 1192, and the money that should be refunded was RMB 896,000. But, defendant asked to deduct from the refund the unpaid fees associated with the use of the sold cards, to which plaintiff disagreed. After several unsuccessful negotiations, plaintiff brought this lawsuit against defendant for (a) RMB 896,000 that should be refunded to plaintiff plus late payment penalty, (b) RMB 358,760 of the loss of plaintiff expected interests caused by defendant's unilateral termination of the contract, and (c) litigation fees.

Defendant argued that the money to be refunded should be RMB 747,744.42 rather than RMB 896,000 because under the Agreement plaintiff shall be responsible for the costs such as mobile network charges and unpaid long distance charges related to the use of the SIM and such costs shall be deducted. Defendant also argued that although defendant shall refund to plaintiff RMB 747,744.42, the payment was withheld according to the court order on April 25, 2000 pending the disputes over the refund money. Therefore, defendant should not be asked to pay to any late payment penalty. Defendant further argued that plaintiff's claim should be dismissed because the dissolution of the contract by defendant was not a breach of the contract because defendant had to comply with the State policy on charges and fees for cellular phone services, and the parties had agreed that the both parties would bear the risks due to the change of the State policy that makes the parties unable to continue selling the SIM cards.

It was found during the court hearing that the outright purchase agreement was signed by the parties on February 17, 2000, and after the sales was stopped the unsold cards amounted to RMB 896,000 that should be refunded by defendant to plaintiff. It was also found that there was no credible evidence to prove the costs that defendant claimed for deduction, and that the withholding of the payment of the refunded money was granted by the order of Kun Ming Intermediate People's Court (2000 *Kun Fa Jing Chu Zhi* No. 22).

The Court then holds that defendant's assertion for deduction was not supported by evidence and therefore should not stand. The Court further holds that defendant should not be penalized for the late payment of the refund because the delay in payment was granted by the court order, and for that reason plaintiff's claim for late payment penalty must be denied. With regard to the change of the State Policy, it is the opinion of the Court that defendant's dissolution of the agreement was not a result of the change of the State policy because the fee standard employed by defendant was not in compliance with the State standard of changes and fees for the cellular phone serves, and the notice of the Ministry of Information Industries was aimed at enhancing the administration of the charges and fees employed by the cellular phone services provider and there was nothing to do with the policy change.

Therefore, the court concludes that defendant's termination of the agreement did not fall within the coverage of the condition of the government policy adjustment as agreed by the parties because there was no change of government policy. On this ground, defendant's termination of the agreement constituted a breach of contract for which defendant must be held liable. In the meantime, because of defendant's breach of contract, plaintiff suffered the loss of the expected interest of RMB 358,760 arising from the unsold cards. Thus, plaintiff's claim for the expected interest shall be granted.

In view of the above analysis and in accordance with Article 64 (1) of the Civil Procedure Law of China and Articles 93 (1), 97 and 113 of the Contract Law of China, it is ordered that:

1. The "Sales Agreement on Outright Purchase of '130 Teng Si Lin SIM Card' Linked to China Unicom GSM 130" entered by the parties on February 17, 2000 be dissolved;

2. Defendant China Unicom, Inc. Yun Nan Branch refund to plaintiff RMB 896,000 Yuan within 10 days after this judgment takes effect;
3. Defendant China Unicom, Inc. Yun Nan Branch pay plaintiff RMB 358,760 Yuan as plaintiff's loss of expected interests; and
4. Plaintiff's other claims be dismissed.

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In *China Unicom*, the court denied defendant's assertion of the State policy adjustment as the defense for unilateral dissolution of the contract because, according to the court, to cure the defect in compliance with the State policy on charges and fees did not constitute a change of the State policy for which the unilateral dissolution of the contract would be allowed. The court decision, however, does confirm the notion that the change of the State policy that affects a contract would be taken as a condition on which the contract is to be dissolved. But what seems typical in this case is that the court deemed "the change of government policy" as a "dissolving condition" provided by the parties through their agreement.

1.4. Legal Consequences of Dissolution

For the dissolution of a contract either by agreement or for statutory reasons, the right to dissolve must be exercised by the aggrieved party. Also, as required in Article 96 of the Contract Law, if the aggrieved party advances to dissolve the contract, it shall send a notice to the other party, and the dissolution will not become effective until arrival of the notice at the other party. In the meantime, Article 96 gives the aggrieved party a cause of action to ask the court or arbitration body to affirm the validity of the dissolution if the other party disagrees therewith.[22]

The Contract Law makes no indication about whether the notice must be in writing. Generally, if the contract is made in writing, the dissolution notice shall also be in writing. Once again, for certain contracts, an approval or registration is required for the dissolution. Unfortunately, in these cases, without the "red chops" from relevant government authority, no dissolution will become valid. If however, only filing is required, failure to file may not affect the validity of the dissolution, but may result in administrative fines.

As discussed above, the right of dissolution is provided either by agreement or by law. But the exercise of such right may be subject to certain time limit, and the time limit may be a statutory one or a consensual one. Under Article 95 of the Contract Law, where the law stipulates or the parties agreed upon the

[22] See the Contract Law, art. 96.

time limit to exercise the right to dissolve a contract, failure to exercise within the time limit will cause the right extinguished.[23] If, however, there is no legal provision or agreement on the time limit, Article 95 requires that such a right be exercised within a reasonable period of time after being urged by the other party. Or otherwise the right will also be extinguished.

The legal consequence of the dissolution is to end the contract relationship between the parties. As we recall, under the Contract Law, dissolution not only terminates the contract but also retroactively affects part of the contract that has been performed. Thus, Article 97 of the Contract Law provides two situations concerning the dissolution. First, after the dissolution, if the contract has not yet been performance, the performance is terminated. Second, if the contract has been performed, restitution, other remedial measures or damages may be claimed depending on the amount of performance as well as the nature of the Contract.[24]

Obviously, for a contract that has not yet been performed, the dissolution is simply a matter of cancellation of the performance. If the contract has been performed, certain complexity would present because the performance may result in the conveyance of benefits between the parties. To cope with this complexity, Article 97 makes available to the parties three different alternatives: restitution, other remedial measures or damages. The seemingly easiest one is restitution, which is aimed at restoring the parties to the position where they would stand if the contract had not been performed. The restitution basically involves return of originals plus interests accrued and necessary expenses.

The other remedial measures may require further explanations. On the one hand, they are not specified in the Contract Law, and on the other hand, scholars differ sharply on what would fall within other remedial measures. Some suggest that the other remedial measures mainly include repair and replacement that will be used in the cases where it is impossible or extremely difficult to restore the original. Others argue that the other remedial measures are referred to as the means such as reduction of price or payment, or claim for unjust enrichment. A few regard the other remedial measures as the way to supplement the restitution. For example, if the restitution is not sufficient, the aggrieved party may also ask for the stipulated damages. In practice, because of the lack of unified interpretation, the courts may view the other remedial measures in the way they see appropriate.

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[23] See *id*., art. 95.

[24] Keep in mind that the retroactive effect of dissolution only affects the contract or part of the contract that has been performed. For the contract or part of the contract that has not yet been performed, the retroactivity is not an issue.

In case of dissolution, the aggrieved party may also ask for damages. In contract theory, there is long lasting debate in China on whether dissolution and damage may co-exist, or in other words whether the aggrieved part may make a claim for damage while dissolving the contract. By giving the dissolving party the right to seek for damages, the Contract Law stands on the position that dissolution and damage are not necessarily mutually exclusive.[25] This position has its authoritative source from Article 115 of the 1986 Civil Code, which provides that in modification or dissolution of a contract, the party's right to seek for damages shall not be affected. Thus, under Article 97 of the Contract Law, after dissolution, the interested party may ask for restitution or other remedial measures, and may also be entitled to damages.

The doctrinal basis for allowing damages in dissolution is fairness. First of all, if a contract is dissolved due to a party's breach of contract, it is fair to ask the party in breach to bear the liability corresponding to its breach because the other party may have experienced the loss of benefits or interests caused by the breach.[26] Secondly, the dissolution would free the parties from their contractual obligations, but it does not necessarily means that the damages the aggrieved party may have suffered would be properly compensated without damage remedy. Thirdly, although restitution is, of course, the legal remedy, such a remedy might not be sufficient because the restitution is to bring the parties back to their position before the contract, but it may not cover the losses and damages, particularly when the contract subject matter was destroyed and could not be restored or returned, which makes the restitution totally meaningless.

Practically speaking, the difficult issue is not whether the damages shall be made available where a contract is dissolved. What is thorny here is what should be covered in the damages. The questions raised are whether the aggrieved party may be compensated for both the damages in association with the institution after the dissolution and the damages that may incur as a result of non-performance of the contract, and whether the damages will be only the direct damages or should also include indirect damages, such as lost interests. In the sense in which the aggrieved party may be compensated in case of dissolution, there exist different doctrines in China. One doctrine is called "complete

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[25] Some believe that dissolution and damages may not co-exist. The rationale is that dissolution will only result in restitution, and because of the restitution that restores the parties to their original status, it would mean that the contract did not exist from the very beginning. Therefore, without existence of the contract, there would no bases on which the damages may stand.

[26] In this sense, if the dissolution is caused by *force majeure* without the fault of any party, the remedy for damages will become irrelevant.

compensation" according to which the aggrieved party is entitled to all damages it may have had, including both damages caused by non-performance and damages related to restitution.[27] The other doctrine takes a narrower view that the damages only cover the losses resulting from non-performance.[28]

The damages related to restitution are illustrated by some scholars in China to include (a) necessary expenses spent for the formation of the contract, (b) costs for the preparation for the performance of the contract, (c) opportunity cost, (d) loss caused by the failure to return the originals, and (e) other additional costs incurred to the aggrieved party as a result of the dissolution.[29] The non-performance damages normally refer to expectation interest and reliance interest. But in Chinese courts, there is a strong opinion against compensation for expectation interest in dissolution. The argument is rested with the proposition that the primary effect of dissolution is restitution while the expectation interest may take place only after the contract has been performed; when the parties choose to dissolve the contract, it implies that the aggrieved party is unwilling to continue performing the contract, and therefore, the party shall not be compensated for the interest that it is supposed to obtain after the completion of the performance of the contract.[30]

2. Termination

Like dissolution, termination also has the effect to end the contract, but for different reasons. Generally, the termination discharges both the rights and obligations of the contractual parties, whereby the performance of contract is called to a complete stop. In the civil law context, the termination of a contract is part of the extinguishment of the *obligitio* because it extinguishes the relationship of contractual rights and obligations. As noted, the termination may only affect the contract to the extent of unperformed obligations. From this perspective, the termination will render the contract ineffective from the date of the termination, but will not touch the effectiveness of the contract at the beginning.

The Contract Law provides a laundry list of the causes to terminate a contract. In accordance with Article 91 of the Contract Law, a contract is terminated under any of the following situations: (a) the obligations have been

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[27] See Wang Liming, *supra* note 1 at p. 305.

[28] See Dong Ling, *supra* note 7 at pp. 217–218.

[29] See *id*. at p. 218.

[30] See Li Guoguang, *Explanation and Application of the Contract Law*, 381 (Xinghua Press) (1999).

performed according to the terms of the contract, (b) the contract has been dissolved, (c) the obligations have been offset against each other, (d) the obligor has deposited the contract subject matter with certain authority under the law, (e) the obligations have been exempted by the obligee, (f) the contractual rights and obligations have been assumed by the same person, or (g) other circumstances for termination as provided by law or agreed upon by the parties.[31] As discussed at the beginning of this chapter, dissolution in Article 91 of the Contract Law is listed as a cause to terminate a contract. But because of the distinction of dissolution, if a contract is terminated as result of dissolution, the termination may retroactively affect the contract before the termination, which means that the restitution or non-performance damages that otherwise will not be available in the termination may be sought.

To simplify, under Article 91 of the Contract Law, a contract could be discharged by performance, dissolution, offset, deposit, release, assumption of both debts and credits, agreement of the parties, or operation of law. The obviously legal effect of termination is to extinguish the contract. But in China, there are in addition at least two major effects that the termination has on the contractual parties. The first effect is the right to seek for damages. The termination will not abrogate the right of a party to seek for damages resulting from the breach of contract caused by the other party. On the contrary, after the termination, the aggrieved party is entitled to the compensation for the damages if the other party is found to have breached the contract.

Moreover, if the contract contains terms for account settlement and clearance, the terms shall survive the termination, and remain effective. This rule is also called "independence" rule and is adopted by the Contract Law. Article 98 of the Contract Law provides that the termination of the rights and obligations of a contract may not affect the effectiveness of the settlement and clearance clause in the contract.[32] The same rule also applies to the dispute resolution clause agreed upon by the parties, including both litigation and arbitration.

The second effect concerns the after-termination obligations. It is true that when a contract is terminated, the contractual relationship between the parties is extinguished. But for the sake of business interests, the parties are required to bear certain obligations to each other. Under Article 92 of the Contract Law, when the contractual rights and obligations are terminated, the parties to a contract shall, in compliance with the good faith principle or according to transaction practices, perform such obligations as giving notice, providing assistance as well as maintaining confidentiality.[33] Thus, the notice, assistance

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[31] See the Contract Law, art. 91.

[32] See *id*., art. 98.

[33] See *id*., art. 92.

and confidentiality are the three major obligations that the Contract Law imposes on the parties to a contract after the contract is terminated.

It has been argued, however, that the after-termination obligations are no longer the contractual obligations because the contract has been terminated. Then the question is what would be the legal base for the after-termination obligations that the parties are required to bear. In other words, what would be the cause of action for the aggrieved party to sue the other party who fails to perform the after-termination obligations? Apparently, Article 92 of the Contract Law premises the after-termination obligations on the good faith principle and transaction usages. Thus the failure to perform such obligations is treated under the Contract Law as a violation of good faith principle or transaction usages that will trigger certain liabilities. A different approach is to deem the after-termination obligations as torts liabilities, and imposition of such liabilities is to protect the business interests of the parties from being infringed after the contract is terminated.

2.1. Termination by Performance

A contract is discharged after it has been performed. In China, for purposes of discharge, the performance is required to be the one that is appropriate, correct and complete. In this sense, a commonly used term that indicates the performance is called "clear-off" of contractual obligations. "Appropriate" means that the contract is being performed according to the conditions and terms agreed upon by the parties, or in compliance with good faith principle or provision of law in the case where certain terms of the contract are not clearly defined. For example, if there exists ambiguity with regard to the place of performance or the time of performance, the ambiguity would need to be clarified under the good faith principle or the provision of law absent agreement of the parties.

"Correct" requires that there be no defects in the performance. Normally, a contract is to be performed by obligor to obligee. But in terms of "clear-off", the contractual obligations may be satisfied either by obligor or by a third party as long as the terms and conditions of the contract are met. From the obligee's point of review, what matters is whether the obligee's creditor interests will be realized no matter who is going to clear off the debts unless the exclusive performance by the obligor is required.[34] Additionally, to assure that the performance is correct, the obligations should be cleared off by the delivery

[34] As noted, a contract may only be performed by the parties if (1) the third party's performance is prohibited by the agreement of the parties or (2) the nature of the contract precludes the performance by a third party.

of the same items or services as agreed. However, there has been a discussion about whether the "clear-off" of obligations may be made by substitute items, for example, to pay off the monetary debts by specific goods or the goods of a kind. The proponents suggest that the substitute items should have the effect to satisfy the obligations as long as the substitute has the same value and is agreed by the obligee.[35]

"Complete" means the satisfaction of the debts or achievement of the contract purpose, whereby the contract is terminated. According to many Chinese contract scholars, there is a slight difference between the performance and "clear-off", thought both are the legal conducts purposed to realize the creditor's rights.[36] Performance is to satisfy the creditor's rights in order to accomplish the purpose of the contract. "Clear-off" is aimed at discharging (terminating) the contract through the satisfaction of the creditor's rights.[37] Indeed, it seems unclear as to what practical significance the difference would serve, but the idea is that for a contract to be terminated via performance, the performance must be fully complete.

2.2. Termination by Offset

Offset applies where the parties are mutually obligated to each other, and the contractual obligations may be discharged to the amount that is offset. To illustrate, if A owes B $1,000 for the goods B delivered, while B owes A $1,200 for the services A provided, the two debts may be offset because A and B are both obligee and obligor to each other. After the offset, the $1,000 debts that A and B each owes to the other will be discharged, but B still owes $200 to A. As it can be seen, one big advantage to offset contractual obligations is the efficiency in clearing off the contractual obligations.[38]

In addition to the contracts, the offset in China is also used in bankruptcy process. Under Article 33 of the Enterprise Bankruptcy Law of China (1986), if the creditor is liable for the debts of the enterprise in bankruptcy, the credits will be offset against the debts before the bankrupt clearance. The purpose is to prevent the occurrence of a dilemma that the party not in bankruptcy may

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[35] See Dong Ling, *supra* note 7 at pp. 179–180.

[36] Few scholars deem the "clear-off" as legal fact other than conduct because they believe that the "clear-off" is a result of performance (e.g. delivery).

[37] Fee Jiang Ping, *supra* note 17 at p. 74.

[38] In China, some scholars view the offset to have a function of guarantee of performance of the contract. The reason is that since the parties are both obligee and obligor to each other, the creditor right of one party would be safeguarded by his obligations owed to the other party, and *vice versa*.

face: it remains liable for the debts it owes to the bankrupted party, but it may have to have its credit satisfied through the process of bankruptcy depending ultimately on the availability of the assets left over from the bankrupted party.

The Contract Law adopts the offset mechanism and makes it a terminator of a contract. As provided in the Contract Law, there are two kinds of offsets: offset by law and offset by agreement. The offset by law, also named as statutory offset, is the one that meets the requirements of law and may be exercised through the operation of law. Under Article 99 of the Contract Law, where the parties to a contract have the debts mutually due, and the type and character of the debts are the same, any party may offset his debts against the debts of the other party, except that such debts may not be offset pursuant to the provisions of the law or the nature of the contract.[39]

Article 99 of the Contract Law appears to have set forth several tests for the statutory offset. The first test is mutuality. In order to offset, the obligations must be the ones mutually owed to each other by the parties to a contract. The second test is maturity. The offset obligations not only must be mutually owed but also must be mutually due. If one party's obligation is due and the other is not, the two obligations could not be offset. The third test is identity. The identity requires that the obligations to be offset must be in the same category and have the same character (i.e. quality). For example, if the parties owe money to each other, the monetary debts could be offset because they are regarded as in the same category and being the same quality.[40] The forth test is qualification. If the obligations are not allowed to be offset either by the "provisions of the law" or by the "nature of contract", the obligations are not qualified for offset.[41]

If all above tests are met, any party may initiate to offset the contractual obligations. But the Contract Law requires that the initiating party manifest his intent to offset by giving a notice to the other party. Under the Article 99

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[39] See the Contract Law, art. 99.

[40] This matter will become more complicated if two non-monetary "things" are involved. If the two "things" both are specific items, such as the antiques, they may not be offset because they are unique and each could not be replaced. If the two things are the items of a kind, there may be an offset if they are in the same quality.

[41] Generally, the obligations that may not be offset by the provisions of the law include, among others, (a) the debts for which the payment may not be coercively enforced, e.g. debtor's money or assets that are the necessity for living or family support; (b) wrongdoer's obligations arising from intentional torts; (c) the obligations that out to be performed to a third party; (d) the obligations serving the third party's interest. See Dong Ling, *supra* note 7 at pp. 227–228. Some scholars also suggest that uncertain or conditional creditor rights should not be offset until the rights become certain or the conditions are met.

of the Contact Law, a party advancing to offset the debts shall notify the other party, and notice shall take effect upon arrival at the other party. In addition, Article 99 provides that the offset may not be accompanied by any conditions or time limits. Accordingly, the Article 99 offset is a unilateral conduct of the initiating party and becomes effective when the notice of the offset is received. The preclusion of conditions and time limits derives from the unilateral character of the offset because the manifestation of the intent to offset need to be certain and shall be operative as long as the legal requirements are met.

The offset may also be made by the agreement of the parties. According to Article 100 of the Contract Law, where the parties to a contract have mutual debts but the type and character of the debts are different, the debts may be offset against each other if the parties reach a consensus through negotiation. It can be easily seen from Article 100 that the requirements for the consensual offset are less restrictive than those of statutory offset. In consensual offset, the debt obligations in questions may differ in types and characters. In addition, the maturity is not an element in consensual offset, and thus a debt obligation that is due may be offset against the one that is not due, or two undue debt obligations may also be offset against each other under the agreement of the parties.

In practice, the consensual offset may take different forms. The parties may offset their mutual debt obligations through an agreement that is separated from their contract. The parties may also make a provision or clause in their contract that set forth terms or conditions under which their mutual debts may be offset. Of course, the parties may through their contract prohibit consensual offset of mutual obligations. In consensual offset, the parties often set forth procedures and accounting measures for conducting the offset. In sales contracts for example, it is quite common that the parties agree to periodically offset their mutual debt obligations (delivery of goods and payments), and after the offset, whoever still owes a fraction of debts to the other party need only satisfy the fractional debts.

2.3. Termination by Deposit

In the context of the Contract Law, deposit means to submit the unperformed contractual obligations to certain authorities due to the reasons that are uncontrollable from the perspective of the obligor, and as a result the obligor's obligation to perform is then discharged. Since deposit has the legal consequence of terminating a contract, it only applies where it is difficult for the obligor to perform. The primary purpose of the deposit is to protect the legitimate interest of the obligor because without deposit the obligor may always be and remain liable for the unperformed obligations even though the performance is extremely difficult.

The deposit thus is designed to help release the obligor from being liable for performance if there is no way for the obligor to perform. Note that the

"difficulty" here refers to the situation where the obligor is capable and willing to perform, but for certain reasons the performance could not be conducted without the obligor's fault. The underlying rationale for having the deposit is to help keep the interests of the parties to the contract fairly balanced.

To make a deposit of contractual obligations, there must present legal ground mandated by the law. In China, the deposit rule was officially adopted first by the Supreme People's Court in 1988 when the Supreme People's Court issued its "*Opinions (Provisional) on Several Matters Concerning Application of the General Principles of the Civil Law*". According to the Supreme People's Court, if the obligee, without good reasons, refuses to accept the performance of the obligor, the obligor may submit the subject matter of the performance to relevant authority for deposit, and after the deposit the obligations of the obligor shall be deemed as having been performed.[42] There the Supreme People's Court clearly granted the deposit an effect to terminate a contract, and made the obligee's unjustified refusal of obligor's performance a legal ground for deposit.

The Contract Law adopts the deposit rule in the way more appealing to the obligor. Pursuant to Article 101 of the Contract Law, under any of the following circumstances, if the debt obligations are difficult to be performed, the obligor may have the subject matter of performance deposited: (a) the obligee refuses to accept the performance without justified reasons; (b) the obligee is missing; (c) the obligee is deceased and the inheritor is not yet determined or the obligee lost his civil conduct capacity and the guardian is not yet ascertained, or (d) other situations as provided by law.[43] All above circumstances state a common ground, that is, the difficulty of performance is caused by obligee, for which the obligor shall not be held liable. After the deposit, the contract is terminated.

The obligee's refusal to accept performance without justified reason normally involves the situation where the obligee should, and is able to, accept the performance, but refuses to do so. But the prerequisite for the deposit is that the obligor is making the performance exactly according to the terms and conditions of the contract. If the obligee has the right to refuse to accept the performance, e.g. the performance that is improper or incomplete, the deposit rule will not apply. It should be pointed out that under the Contract Law, refusal to accept performance implies a delay in acceptance. In the early draft of the Contract Law, it actually was termed as "delay in acceptance". The

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[42] See, Supreme People's Court, "*Opinions (Provisional) on Several Matters Concerning Application of the General Principles of the Civil Law*" 1988, art. 104.

[43] See the Contract Law, art. 101.

term in the draft was later changed to "refusal to accept performance without justified reason" when the Contract Law was adopted.[44] As some scholars explained, refusal to accept performance without justified reason will necessarily lead to a delay in acceptance of performance, or the inevitable outcome of refusal to accept would be the delay in acceptance.[45]

A question that has been raised concerning the refusal to accept performance is whether the obligor may ask for deposit if the obligee is anticipated to repudiate the contract (namely to refuse to accept the obligor's performance). A commonly accepted position is that deposit shall not be applied on the ground of anticipatory repudiation. The major reason is that deposit becomes relevant only when the performance is due because the main theme of deposit is to help obligor overcome the difficult in performance caused by obligee.[46] Therefore, even if the obligee expressly state not to accept the performance before the performance becomes due, the obligor's right to make the deposit will not arise until the due day for the performance passes.

The circumstance where the obligee is missing includes the lack of information about the identity and address of the obligee, out of contact with the obligee, or disappearance of the obligee. Three related issues are important to determine whether there is a missing obligee so that that a deposit by the obligor would be justified. The firs issue concerns the agent (including trustee or estate administrator) of the obligee. If the obligee itself is completely out of touch, but its agent is still available, the performance then may be made to its agent and therefore no request for deposit shall be granted. In this case, the performance would be regarded "not difficult".

The second issue is the cause of missing obligee. The obligor is not entitled to requesting the deposit if the obligee is missing as a result of the conduct of the obligor or his employees. For example, if the missing of the obligee is caused by the threat imposed on the obligee by the obligor or his employee, no deposit would be allowed.[47]

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[44] See Sun Lihai, *Selection of Legislative Materials of the Contract Law of China*, 57 (Law Press, 1999).

[45] See Dong Ling, *supra* note 7 at p. 237.

[46] See Wang Liming, *supra* note 1 at p. 336.

[47] As discussed in Chapter VIII, according to Article 70 of the Contract Law, if the obligee does not notify the obligor of its separation, merger or change of its domicile, which makes it difficult for the obligor to perform the obligations, the obligor may suspend the performance or submit the subject matter of the contract to relative authority for deposit. It is clear under Article 70 that the reason causing the whereabouts of the obligee unknown must be something for which the obligee shall be blamed.

The third issue is legal declaration of the missing obligee. If the obligee is deemed missing, there are two different views on the legal process by which the deposit should be granted. One view is that the status of missing person must be determined through a legal proceeding and declared by the court. Therefore, in the case where the obligee is missing, the deposit shall not be triggered until the obligee is declared to be missing by the court. The other view seems less restrictive. It argues that the deposit is based on the difficulty in performance, and thus as long as it can be proved that there is no way to find the obligee, the obligor shall have the right to request for the deposit regardless of the court declaration of the missing obligee.

A harder question is the time for the obligor to make the deposit. The main point of the question is how long the obligor would have to wait before requesting for the deposit when the whereabouts of the obligee is unknown. The Contract Law contains no indication on the matter of time. But if the determination of missing person must be made by the court, there is a statutory requirement of two years under the Civil Code. Article 20 of the Civil Code provides that if a citizen's whereabouts have been unknown for two years, an interested person may apply to a people's court for a declaration of the citizen as missing. Actually, since many seem to believe that the deposit is not subject to the judicial determination of the missing obligee, the two-year requirement does not apply. What appears to be applicable then is the "reasonable period of time" during or after the performance period.

A deposit may also be justified if the successor or guardian could not be ascertained when the obligee is died or has lost capacity for civil conduct. To allow a deposit in this situation is based on the notion that the death or loss of capacity for civil conduct does not necessarily lead to the extinguishment of debt obligations. It is self-evident that upon the death of the obligee, the debt obligations shall be performed to the obligee's heir or appointed successor, and in case of the obligee's lack of civil conduct capacity, the performance shall be made to its guardian. However, if the successor could not be identified after the death of the obligee or the guardian could not be determined after the obligee lost its civil conduct capacity, the obligor may request for a deposit in order to have the debt obligations timely discharged.

The uncertainty of the heirs (successors) of the deceased obligee may happen in a couple of situations. One situation is that after the death of the obligee, there appear several successors who claim to be entitled to the creditor right of the deceased obligee, and then the obligor has the difficulty to figure out to whom the performance shall be made. The other situation concerns the multiple deaths of the obligee and its heirs (or successors), in which there is no feasible way for the obligor to determine who would be the right person to receive the performance. Normally, the multiple deaths will be followed by

a judicial presumption of the sequence of the death in order to identify the eligible and legitimate successor (s).[48]

In many cases, there is a difficulty in the determination of guardian for an incapable obligee. On the one hand, the range of person who is eligible to become the guardian is very broad. According to Article 17 of the Civil Code, those who may serve as a guardian for mentally ill person without capacity for civil conduct include (a) spouse, (b) parents, (c) adult child, (d) other close relatives, or (e) other related relatives or qualified friends. In practice, there always exist disputes over who should be the guardian.[49] On the other hand, if there is no legal (statutory) guardian or there is a dispute over the guardianship, a guardian should be appointed. The appointment of the guardian has to go through certain legal process, which would take time.[50]

The deposit in any other circumstances must be authorized by the law. The most notable example is the Guaranty Law where a number of provisions permit deposit. For instance, under Article 49 of the Guaranty Law, the proceeds obtained by the mortgager through transfer of the mortgaged property shall first be used to liquidate the claim secured by the mortgage or otherwise the proceeds shall be deposited with a third party agreed upon by the mortgagee. Another example is the Rules of Notarization of Deposit adopted by the Ministry of Justice on June 2, 1995. One of the situations where a deposit may be notarized under the Rules is that the parties agree in their contract to make payment in the form of deposit.[51]

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[48] In its *Opinions in the Matters Concerning Application of the Succession Law of China*, the Supreme People's Court offered a special guidance in determination of successor in the multiple deaths. Article 2 of the Opinions provides: "when several people who have inherent relationship to each other die in the same incident, if the time of the death one after another could not be determined, the person who has no heirs should be assumed to have died first; if the deceased each has heirs and each is in the different generation of the family, the elder member of the family should be assumed to have died first; If the decedents are all in the same generation, they should be assumed to have died simultaneously, and no succession will take place among them, but their each heirs will inherit them respectively."

[49] As it has been observed from the courts practice that the disputes over the appointment of guardian include the following: (1) disputes among the deceased's relatives at the different levels of family relation who argue against each other for the guardian, (2) disputes among the relatives in the different levels of family relations who each tries to shift the guardianship responsibility onto the other, and (3) disputes among the family members either in the situation where all want to become the guardian or in the situation where all refuse to become the guardian. See Li Guoguang, *supra* note 30 at pp. 392–393.

[50] Under Article 17 of the Civil Code, in case of a dispute over guardianship, the work unit of the incapable person or the neighborhood or village committee of his residence shall appoint a guardian among its close relatives. If disagreement over the appointment leads to a lawsuit, the people's court shall make a ruling.

[51] This practice seems like a creation of escrow account for the purpose of payment.

Still, there are certain questions concerning the deposit. A significant one is what could be deposited. The terminology used in the Contract Law is "the subject matter of the obligations", which seems ambiguous. A scholarly interpretation is that the subject matter of obligations in the context of deposit mainly includes monetary items and other things suitable for deposit. Under the Rules of Notarization of Deposit, the items that may be deposited are currency, negotiable instrument, valuable notes, bill of lading, certificate of rights, precious articles, collaterals (money) or substitutes, and other items appropriate for deposit. The items that are regarded not suitable for deposit mainly involve those that are perishable or fast depreciable. In addition, the deposit will also be deemed unsuitable if the costs for the deposit are too high. In accordance with Article 101 of the Contract Law, if the subject matter is not fit for deposit or the deposit expenses are excessively high, the obligor may auction or sell the "thing" concerned and deposit the proceeds obtained therefrom.[52]

Another question is the authority with which the deposit shall be made. The Contract Law does not define the authority, but under the Rules of Notarization of Deposit the notary public office is designated as the authority to accept deposit. Article 2 of the Rules provides that the deposit notarization is the administrative activity to take care of or take custody of the subject matter of the debts or guarantees (including substitutes) submitted by the obligor or guarantor for the benefit of the obligee, and to return them to the obligee when required conditions are met. Many in China believe that the only authority for the deposit is the notary public office. Some, however, argue that the deposit authority shall also include those appointed by the court, such as bank, trust institution, as well as warehouse.

To make the deposit, the obligor would need to make request first with all supporting documents, and when approved by the deposit authority, the obligor shall submit what would be deposited. After the submission the obligor shall be given a certificate of deposit. The certificate will have an evidential function that helps release the obligor from its debt obligations. However, in order to make the deposit effective, the obligor must meet the requirement of notice. According to Article 102 of the Contract Law, after the subject matter is deposited, the obligor shall, except for the missing obligee,

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[52] A dispute over the object of deposit is whether real property could be deposited. One view is that real property may not be deposited because the immovable nature of the real property. When oblilgee refuses to accept the real property, the obligor may not request for deposit but may abandon it. The opposite view argues that the purpose of deposit is to end the debts relation between obligee and obligor, and thus the deposit shall not be denied as to real property because the real property could not be moved, but could be sealed for deposit purpose.

promptly send a notice to the obligee or the obligee's heir or guardian. Without such a notice, the deposit would be deemed to have no effect.[53]

The primary legal consequence of the deposit, as we have discussed, is to free the obligor from its obligations to the obligee. Therefore, after a valid deposit, the obligee will have no any claim against the obligor with regard to the obligations in question, and any request of the obligee to satisfy its creditor rights may only be made to the deposit authority. Also, after the deposit, the burden of risk concerning the deposited subject matter is shifted from the obligor over to the obligee. It is provided in Article 103 of the Contract Law that the risk of damage to and loss of the subject matter after deposit shall be borne by the obligee. On the flip side, Article 103 requires that during the period of deposit, all interests accrued from the deposited subject matter belong to the obligee. In addition, under Article 103, the obligee is responsible for all expenses related to the deposit.[54]

Keep in mind that deposit by no means will deprive the obligee of the rights or interests to the deposited subject matter. It is clear in Article 104 of the Contract Law that the obligee may claim the deposited subject matter at any time. But such a claim by the obligee is not unconditional. Article 104 explicitly states that if the obligee is under a debt due to the obligor, at request of the obligor, the deposit authority shall deny the obligee's claim unless and until the obligee has performed its debt obligations or has provided a guarantee for its performance.[55]

Equally important is the statute of limitation on the obligee's right to claim the deposited subject matter. Although the obligee's right to claim the deposited subject matter remains after the deposit, the right will be lost if not exercised after a certain period of time. As Article 104 mandates, the claim to the deposited subject matter must be made within 5 years after the date of deposit. The deposited subject matter that is not claimed after the 5-year statute of limitation expires shall become the property of the States minus the deposit expenses.

2.4. Termination by Exemption

The obligations of the obligor to a contract may be exempted by the obligee in whole or in part, and after the exemption, the obligations are discharged with regard to the amount that has been exempted. Article 105 of the Contract Law provides that if the obligee exempts the obligor from the debt obligations

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[53] See the Contract Law, art. 103.

[54] See *id*.

[55] See *id*., art. 104.

wholly or in part, the whole or part of the rights and obligations of a contract shall be terminated.[56] Essentially, the exemption of the contract obligations occurs when the obligee willfully gives up or abandons its right to the performance of the obligations, and as a result the obligations exempted are extinguished.

Given the important consequence of the exemption, several elements are required. First of all, the exemption must be voluntarily manifested by the obligee eligible to depose of the right to the performance of the obligations. The eligibility means that the obligee has full civil capacity and the creditor right is free from any claims. For example, if the obligee is a minor or mentally retarded, the exemption must be endorsed by his or her agent *ad litem*. It is important to note that in China, the exemption of contractual obligations is regarded as the unilateral conduct of the obligee, and therefore, the obligor's consent to the exemption is irrelevant.

Secondly, the manifestation of exemption must be made to the obligor. By exemption, the obligee purposes to forgive the obligor's obligations. Consequently, if the exemption is manifested to a third party, it will have no effect to the obligor and the obligor shall remain liable for the obligations. The Contract Law sets forth no requirement as to whether the exemption must be made in writing. It then might be inferred that as long as the exemption is manifested, it could be made in writing or orally.

What seems disputable however is whether the manifestation of exemption could be implied from the obligee's act or conduct. For instance, assume that the obligee made a loan to the obligor, and at the time when the repayment is due, the obligee did not ask for the repayment, but instead returned to the obligor the receipt "certificate" evidencing the loan. It may be proper to hold that the returning of the loan receipt manifests the obligee's intention to cancel the debt.

Thirdly, the exemption may not be made as a bargain with the obligor. To exempt the debt obligations, the obligee may not ask the obligor for something in return. If the existing obligations are to be taken away from the obligor in exchange for other obligations to be imposed on the obligor or in exchange for certain value, there would be no exemption. Rather the bargained outcome would be considered as a modification of the contract or substitute performance.

However, some suggest that the reason for the exemption may be a result of bargain.[57] To illustrate, if the obligee reached an agreement with a third

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[56] See *id*., art. 105.

[57] See Dong Ling, *supra* note 7 at p. 249.

party, under which the third party would exempt the obligor from the obligations on the condition that the obligee will be compensated by the third party, the exemption will be upheld even though there is a bargain between the obligee and the third party. But note again that in order to effectuate the exemption, it must be manifested to the obligor by the obligee. In plain language, the obligee must tell the obligor that the obligations are exempted even if the deal (bargain) for the exemption is being made between the obligee and a third party.

Fourthly, the exemption may not affect the interests of a third party. Often the third party interests will be involved when the creditor's rights in question have been pledged as security. The rule is that if the creditor rights of the obligee are encumbered with security interest, such rights may not be given up without the consent of the holder of the security interest. Thus, the obligee may not exempt the obligor if the exemption will have adverse impact on the third party's interest. For the same reason, the obligations of the obligor may not be exempted if the obligee is in bankruptcy.

An interesting question is whether the manifestation of exemption, once made, may be revoked. This question seems to have not received many discussions, but in practice the courts have the tendency to hold the manifestation of exemption irrevocable.[58] What seems problematical in this regard is whether the reaction of the obligor might need to be considered with regard to the revocability of the manifestation of exemption. But it would appear to be reasonable to allow the obligee to retract the manifestation if (a) the obligor has not received the manifestation or (b) after receiving the manifestation, the obligor has not been in reliance on the manifestation by detrimentally changing the obligor's position.

2.5. Termination by Assumption of Contractual Rights and Obligations

In light of termination of a contract, assumption would become a cause if there is a consolidation of parties or a combination of contractual rights and obligations upon one party. In most cases, the assumption occurs when the obligee and obligor in a contract become the same party through merger or acquisition, and the contractual rights and obligations then are consolidated together. The Assumption may also take place in succession where the

[58] Many judges in the Supreme People's Court prefer to hold that the obligee's manifestation of intent to give up creditor rights shall not be retracted. The reason underlying this position is that the exemption is a unilateral act of the obligee and will take effect after it is manifested to the obligor, and therefore, once the manifestation is made, it becomes irrevocable. See Li Guoguang, supra note 30 at p. 412.

deceased was the creditor or debtor of the successor, or the decedents were the creditor and debtor to each other and they both were succeeded by the same person. After the successor inherited the deceased, the credit rights and debt obligations were combined and the successor became both creditor and debtor. Further more, the contractual rights and obligations may be combined as a result of assignment where the credit rights are assigned to the obligor or the debt obligations are assumed by the obligee.

When both contractual rights and obligations are combined or consolidated within the hands of the same person, the contractual relationship comes to an end and the contract is then terminated. This assumption rule is provided in Article 106 of the Contract Law. Under Article 106, if the creditor's rights and debtor's obligations of a contract are assumed by the same person, the rights and obligations of the contract shall be terminated.[59] However, if a third party interest is involved, the assumption will not lead to a termination of the contract. For example, if the creditor right of the contract is pledged to a third party as a security for debt, the pledged creditor right shall remain intact despite the assumption. In addition, the assumption may also not affect the contractual obligations if so provided by law.

There appear to have several views on the nature of the assumption. One view is called "impossibility". According to the impossibility approach, the assumption will not result in the extinguishment of a contract, but will only render the performance of the contract impossible because of the merger of the obligor and obligee. Another view is based on the theory of "clearance". It argues that when the contractual rights and obligations are assumed by the same person, the debts will be cleared up against the credit, and then the contract is settled. The third view focuses on "achievement of purpose". It emphasizes that the purpose of a contract is to perform the obligations whereby the creditor rights will be satisfied, and the assumption will have the effect of both performance and satisfaction. Thus after the assumption the contract will be terminated because purpose of the contract has been achieved.

The last in the spectrum is the view that the assumption kills the creditor right because nobody may have a creditor right against himself. This view may be best described as the doctrine of "mutuality of contractual rights and obligations". Under this doctrine, there must be at least two parties in a contract, and each has the rights or obligations against the other. Therefore, after the rights and obligations are assumed by the same person, it will be legally meaningless to keep the contract alive. This doctrine has been very well received and is also the underlying rationale of Article 106 of the Contract Law.

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[59] See the Contract Law, art. 106.

Chapter X
Breach of Contracts and Remedies

The parties to a contract that is legally enforceable are obligated to perform the obligations arising from the contract, and failure to perform may constitute a breach of the contract for which the party in breach will be held liable. In case of a breach, the damages will be assessed and legal remedies available to the aggrieved party will be applied against the damages. Although the subject of remedies is regarded as a broad topic, the contents of the remedies basically involve the monetary compensation and non-monetary relief, which of course may have different types.

1. Liability for Breach: A Chinese Concept

In China, a heavily discussed term concerning the remedies for breach of contract is the "liability for breach" – a concept that is claimed as a "product of China".[1] Generally the liability for breach is defined as the civil liability that arises from the conduct of violation of a contract. In describing the liability for breach, however, scholars in China take different views. One view is that the liability for breach is the legal consequence that a party must face if the party fails to perform his obligations under the contract. Another view deems the liability for breach as the responsibility of the party in breach to compensate

[1] See Xing Ying, *Liabilities for Breach of Contract*, 4 (China Legal System Press, 1999).

the damages suffered by the aggrieved party. The third view tries to stress the punishment by characterizing the liability for breach as the legal sanction against the party in breach. The forth view insists that the liability for breach is essentially the legal assurance for the contract performance, and if a party defaults in performance, the other party may ask the court to enforce the contractual rights against the party in default.[2]

There are two notable principles governing liability for breach that have fundamental impacts on Chinese contract law in the remedies. The first is the principle of liability. Under this principle, a person will be legally liable for failure to fulfill what he is obliged to do as required by law. The best example to illustrate this principle is Article 106 of the 1986 Civil Code. It is provided that a citizen or legal person who breaches a contract or fail to fulfill other obligations shall bear civil liability. Obviously, Article 106 attempts to differentiate civil liability from obligation. Scholars have also made efforts to make distinction between liability and obligation. In one book, obligation is defined as the commitment that a party is required to make either under the provision of law or by a contract, and the liability is termed as the consequence in which the party is compelled to continue performing or to take other remedial acts when the party fails to fulfill his obligation.[3] Therefore, the liability is not simply the obligation, but the legal consequence facing the obligor in case the obligor defaults.[4]

The second principle is the doctrine of liability imputation. Liability imputation is the process of determining whether the party in breach shall be responsible for the breach of the contract. If a party is alleged to have breached a contract, before any liability is to be imposed, the question that must first be answered is whether the breach is caused by the party. The next question then will be whether the liability shall be imposed on the party who is found to be in breach. The liability imputation principle requires that the civil liability be imposed for what should be legally blamed. This principle is deemed as the cornerstone of determination of civil liabilities because it establishes standards and rules under which the determination shall be made.

2. Liability Imputation: Fault vs. Strict Liability

In contract law theory, two basic approaches are commonly employed as the standards to impute civil liabilities, namely the fault approach and strict liability (or no fault) approach. The fault approach suggests that a party who

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[2] See *id*., at pp. 5–7.

[3] See Cui Jianyuan, *Studies on Contractual Liabilities*, 3 (Ji Lin People's Publishing House, 1992).

[4] See Wang Liming, *Study on Contract Law (Vol. II)*, 381 (People's University Press, 2003).

fails to perform the contract should not be responsible for damages unless he is found at fault. Thus under the fault approach, the liability of the party who breaches the contract will be determined in consideration of both the conduct of breach and underlying fault of the party. The strict liability or no fault doctrine, on the contrary, allows a party to claim damages if the other party fails to fulfill his contractual obligations regardless of the fault of the failing party. Pursuant to the strict liability doctrine, if the performance of a contract is due, any non-performance will constitute a breach and the fault on the party in breach is irrelevant.

The liability imputation principle has been a center of discussion among Chinese scholars with regard to the issues of breach of a contract. It is mainly because this principle is considered to be decisively influential on the subject of liability for breach in many aspects. In one aspect, the liability imputation principle has direct impact on what may affect the liability for breach. For example, if fault standard is applied, the fault of the party in breach must be found in order to hold the party in breach liable. Another aspect is the burden of proof. Under the strict liability standard, the aggrieved party would only need to present the facts of breach without worrying about whether the party in breach is actually at fault or not. The fault standard, however, would burden the aggrieved party to prove the fault of the party in breach.

Moreover, the liability imputation principle may influence the excuses for non-performance. If the fault of the party in breach is a required element for imposing the liability, the party in breach may be excused if it could be proved that the non-performance was not his fault. Additionally the liability imputation principle may affect the scope of damages. According to the fault standard, the damages may be limited to what were predicted or ought to be predicted by the party in breach at the time of contract. If the parties are both at fault, the damages will be determined in consideration of the degree of the fault of each party.[5]

The Contract Law on its face appears to be vague as to what standard of the liability for breach is being employed. Before the Contract Law was adopted, the fault standard was generally considered as the primary standard to determine the civil liability in China.[6] Although this general view may be debatable,

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[5] For general discussion, see Wang Liming, *id*., at p. 412–413. Others also view that the liability imputation principle may determine the means of damages, and the liquidated damages would be the primary means for compensating damages under the negligence standard. See Li Guoguang, *Explanation and Application of the Contract Law*, 418–419 (Xinghua Press, 1999).

[6] In Article 29 of 1993 Economic Law, it was provided that if, due to the fault of one party, an economic contract cannot be performed or cannot be fully performed, the party at fault shall be liable for breach of the contract.

the most authoritative proposition can be seen from the legislative history of the 1986 Civil Code. When the daft civil code was submitted to the National People's Congress (NPC) for vote, the Standing Committee of the NPC, in its explanation to the draft, clearly indicated that the primary standard in determination of civil liability in China was the principle of fault, and therefore the civil liability was imposed only on those who were found at fault.[7] Then a general inference in China was, and still is, that the fault standard is the underlying theme of the 1986 Civil Code.[8]

Perhaps the most controversial provision concerning the standard of liability for breach is Article 107 of the Contract Law. Article 107 provides that where a contracting party fails to perform the contract obligations or the performance is not in conformity with the contract terms and conditions, the party shall bear such liabilities for breach of contract as to continue performing the contract, to take remedial measures, or to compensate the aggrieved party for loss.[9] The language of Article 107 is simple, but the controversy is whether Article 107 has abandoned the fault principle and adopted the strict liability principle instead.

The opinion at one extreme argues that Article 107 of the Contract Law implies the adoption of the strict liability principle in the contract. Therefore, the very basic meaning of Article 107 is that as long as the obligor fails to perform contractual obligations or the performance does not conform to the terms or conditions of the contract, the obligor must bear the liability for breach regardless of his fault. It is further argued that the implication of the strict liability in Article 107 is reinforced in Article 117 of the Contract Law. Under Article 117, if a contract could not be performed because of *force majeure*, the liability may be exempted in part or fully in light of the effect and degree of *force majeure*, except as otherwise provided by law. The argument is that the primary notion of Article 117 is that *force majeure* may not necessarily exempt a party from contractual obligations.

The opinion at the other extreme insists that the Contract Law is still within the system of the 1986 Civil Code, and does not change the tradition in China that bases the civil liability on the principle of fault. One concern of those who hold this argument seems that if the civil liability standard is to be changed from the fault to strict liability it will not only cause confusion among the

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[7] See Gu Angran, *Talks on Contract Law of China*, 44–46 (Law Press, 1999).

[8] For example, Article 106 of the Civil Code provides: "Citizens and legal persons who through their fault encroach upon State or collective property, or the property or person of other people shall bear civil liability. If stipulated by law, the civil liability shall still be imposed in the absence of fault".

[9] See the Contract Law, art. 107.

judges who are used to the concept of fault but also will be inconsistent with the Civil Code. They argue that as a matter of fact, the Contract Law stays with the fault principle in a number of areas such as pre-contractual liability, reasonably foreseeable loss or risk, mitigation rule, burden of risk, and the like.

Between the two extremes is the majority opinion that the Contract Law contains both the fault and the strict liability standards with an emphasis on the strict liability. According to the majority, the Contract Law, in principle, has departed from the traditional notion of fault, and adopted the strict liability as the primary standard to determine the liability for breach. This change also reflects the need to follow the main stream in the practice of international business transactions. In this regard, the Contract Law is said to have actually followed the strict liability standard as used in both the United Nations Convention on Contracts for International Sale of Goods and UNIDROIT Principles of International Commercial Contracts.[10]

On the other hand, however, the majority view is that the fault approach as embedded in the 1986 Civil Code has not been abandoned, and on the contrary, the Contract Law contains many rules that are fault-based.[11] For example, under Article 189 of the Contract Law, if in a donation contract the donated property is destructed or lost due to the deliberate intention or gross negligence of the donor, the donor shall be liable for damages.[12]

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[10] For example, according to Article 7.4.1 of the Principles of International Commercial Contracts, any non-performance gives the aggrieved party a right to damages either exclusively or in conjunction with any other remedies except where the non-performance is excused under these Principles. A similar provision can be seen in Article 45 of the International Sale of Goods, which provides that (1) if the seller fails to perform any of his obligations under the contract... the buyer may (a) exercise the rights provided in articles 46 to 52; (b) claim damages as provided in articles 74–77. By this language, the Convention is said to have rejected the fault principle. See John Honnold, *Uniform Law for International Sales (3rd ed)*, 276–277 (Kluwer Law International, 1999).

[11] During the drafting of the Contract Law, the prevailing idea was that the liability for breach should be determined under the standard of the strict liability, but the fault approach shall still be used in the areas such as pre-contractual liability, void contract and voidable contract. See Sun Lihai, *Selection of Legislative Materials of the Contract Law of China*, 58 (Law Publishing House, 1999). For example, in January 1995 draft, Article 138 provided that one party to a contract shall bear the liability for breach of the contract if it fails to perform the contract or its performance does not meet the requirements stipulated by law or agreed upon by the parties, except that the party itself is able to prove that it is not at fault. The "not at fault" exception was soon rejected because of the popular opinions in favor of the strict liability in general. See Civil Law Division of the Standing Committee of the National People's Congress, *Introduction to the Contract Law of China and its Important Drafts*, 108–109 (Law Press, 2000).

[12] There are many provisions in the Contract Law that embrace the fault standard. These provisions include such articles as 191, 222, 227, 265, 303, 320, 374, 406, and 425.

3. Breach

According to the Contract Law, the breach of a contract occurs where there is an anticipated repudiation or an actual breach. As we have noted, the anticipatory repudiation is a concept borrowed into the Contract Law from the common law system. Under Article 94 (2) of the Contract Law, an anticipatory repudiation may give rise to a claim for the aggrieved party to dissolve the contract. Article 108 further provides that where a party to a contract expresses explicitly or indicates through its acts that it will not perform the contract, the other party may demand the repudiating party to bear the liability for the breach of contract before the performance period expires.[13]

Compared with Article 94 (2) of the Contract Law, Article 108 more specifically addresses the elements that constitute anticipatory repudiation. In order to hold the repudiating party liable for the breach of contract on the ground of anticipatory repudiation, it must be shown that the non-performance is explicitly expressed or could be clearly inferred from the repudiating party's conduct, and such expression or conduct must be made before the end of performance period. Pursuant to Article 108, in case of anticipatory repudiation, the aggrieved party may directly sue for damages on the cause of action of breach of contract.

The actual breach is a failure to perform the contract after the performance is due. Under Article 107 of the Contract Law, the failure to perform is divided into two categories: non-performance of contract obligation and non-conforming performance. The non-performance is referred to a complete failure to perform the contact obligations, while the non-conforming performance represents a partial failure in performance. The terms non-performance and breach of contract may be interchangeably used in many places. In china, nevertheless, there is a suggestion that the non-performance should not be deemed as the synonym for the breach of contract because beach is a violation of the contractual obligation in general, but the non-performance may only be a kind of such violation.[14]

The non-performance of contract may include both impossibility of performance and refusal to perform. The impossibility is understood in China to mean that there is no way or no practical way to perform. The notion is the classic maxim of "*impossibilium nulla obligatio est*", meaning that there is no

[13] See the Contract Law, art. 108.

[14] For example, the breach of contract may occur where there is a violation of the principle of good faith, which is not necessarily the non-performance. See Wang Liming, supra note 4 at pp. 445–446.

obligation to do impossible things. A performance may become impossible either objectively, e.g. as a result of the power of *Mother Nature*, or subjectively, e.g. the impossibility from the perspective of a contractual party to perform (the contract may still possibly be performed by others).

Refusal to perform is that after the performance becomes due the obligor who is able to perform does not, or does not want to, perform without reasonable grounds. The reasonable grounds in this regard consist of all legitimate reasons provided by law to allow the obligor not to perform. For instance, a party to a contract may refuse to perform under the defense of simultaneous fulfillment plea if the other party is mutually obligated to perform but fails to do it.

Non-conforming performance means that the obligor has performed the contract but the performance is either incomplete or improper because it does not conform to the requirements of the contract. In other words, the non-conforming performance is the performance that violates the principle of completion and properness. The performance will be deemed as incomplete if only partial obligations of the contract have been fulfilled during the required time of performance. The properness requires that the contract be performed in the way that the quality, quantity, time, location as well as manner of the performance match the terms and conditions as agreed upon by the parties to the contract. Thus, both delayed or advance performance would fall within the category of improper performance.

Again note that there are no UCC-type rules in China that govern sales. Like many other contacts, the contract for sale of goods in China is under the umbrella of the general provisions of the Contract Law although the Contract Law in its specific provisions contains a special chapter for the contract for sales. Therefore, there is no such rule as "mirror image rule" or "perfect tender rule" that applies to sales specifically. All general rules in the Contract Law, e.g. liability for breach, that apply to all other contracts will equally apply to the contract for sales.

As briefly mentioned in the previous chapter of this book, there is a non-Chinese concept that, as many argue, has been embodied in the Contract Law – the concept of fundamental breach of contract. As defined in Article 25 of the United Nations Convention on Contracts for International Sale of Goods, a breach of contract is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract. Many in China believe that the test to ascertain whether the breach is fundamental is whether the purpose of the contract has been destroyed or whether the aggrieved party has suffered substantial damages.[15] They argue

[15] See Wang Liming, *supra* note 4 at p. 490. See also Xing Ying, *supra* note 1 at pp. 86–95.

that under the Contract Law, if the beach is fundamental, the aggrieved party may either dissolve the contract or refuse to accept the performance.[16]

However, whatever arguments there might be with regard to liability for breach and the types of breach, a breach of the contract will be found in China under Article 107 of the Contract Law if a party fails to perform the contract or the performance does not meet the requirements of the contract. Therefore, after the performance is due, the non-performance and non-conforming performance are the two very basic types of beach under the Contract Law.

4. Remedies

Remedies, as provided in Article 107 of the Contract Law, take three forms: continuing performance, remedial measures, or damages. It is important to note that the Contract Law has made progress in dealing with contractual remedies in at least three aspects: (1) there is no preferential emphasis on any of the remedies and all remedies are optional to the aggrieved party;[17] (2) the extent to which the aggrieved party may seek remedies is broader than any previous contract legislation; and (3) much of the remedies provided for breach of contracts are compensatory rather than punitive in nature.

Thus, in either non-performance or non-conforming performance, the aggrieved party may choose from the above three remedy forms. In addition, according Article 112, if as a result of non-performance or non-conforming performance, the aggrieved party suffers from other loss, the party in breach shall, after performing its obligations or taking remedial measures, compensate the aggrieved party for the loss. Furthermore, since the breach of contract could be in the form of anticipatory repudiation, the non-repudiating party may choose to sue the repudiating party for breach of contract.

4.1. Continuing Performance

Continuing performance requires that in case of breach the party in breach, upon the demand of the aggrieved party, continue to perform the contract obligations

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[16] One of the most commonly cited provisions in the Contract Law to support this argument is Article 148 of the Contract Law. According to Article 148, if the quality of the goods fails to satisfy the quality requirements whereby the purpose of the contract could not be realized, the buyer may refuse to accept the goods or may dissolve the contract.

[17] Previously, the contract legislation in China placed much emphasis on equitable principle of specific performance. The contractual parties in general were obligated to perform their contractual obligation and were not permitted to breach and pay stipulated penalties or compensatory damages instead of performing. Because of the State's controlling role in the economy, the specific performance was deemed as a dogma of contract law. See Wang Liming, *China's Proposed Uniform Contract Code*, 31 St. Mary's L.J. 7 (1999) at pp. 15–16.

if the performance is possible. Since the continuing performance is purposed to have the contract performed as agreed, there would be no substitute performance. In this sense, the continuing performance is also deemed as specific performance or actual performance because it involves compelling the party in breach to complete the contract performance. The ultimate goal of the continuing performance is to help achieve what the parties have bargained for in their contract. Importantly, it should be pointed out that continuing performance in China is not an equitable relief but a statutory remedy.

A quite number of scholars in China also term the continuing performance as the compelled performance. The reason is that although the continuing performance is to make the party in breach to honor the contract, the performance is in fact compelled by the law as a remedy to satisfy the aggrieved party. Unlike the performance under the contract, which is conducted by the performing party on a voluntary basis, the continuing performance is the legal obligation that would be enforced through compulsion.[18] It is on this ground that the Contract Law makes the continuing performance a type of liability for a breach of the contract.

In the past, however, the continuing performance was employed in China mainly to ensure that the state plan would be accomplished. For example, in Article 11 of the Economic Contract Law of China, it was required if the business transactions involved the State compulsory plan or projects, the contract must be concluded in accordance with the plan issued by the State. At that time, due to the concern about implementation of the State plan, the continuing performance was perhaps the most practical device to handle breach of the contract.

A significant change in the Contract Law is that the continuing performance is no longer the means to help implement the State plan but a contractual remedy available to the aggrieved party. Unfortunately, what needs to be further addressed is how the continuing performance should be enforced upon the aggrieved party's request because the Contract Law is not clear on this issue. The other issue to which an answer needs to be sought concerns whether the aggrieved party may directly ask a competent court to compel the party in breach for continuing performance regardless of the arbitration clause in the contract.[19] In China, since a valid arbitration clause has the effect of precluding a court jurisdiction,[20] it then might be inferred that if there is an

[18] See Xing Ying, *supra* note 1 at p. 126.

[19] The general rule is that the arbitration clause precludes the court jurisdiction.

[20] Under Article 5 of the Arbitration Law of China (1994), if the parties have reached an arbitration agreement, and one party institutes an action in a people's court, the people's court shall not take the case unless the arbitration agreement is null and void.

arbitration clause, the judicial remedy will not be available with an exception that the arbitration clause is invalid or the arbitral award is set aside by the court.[21]

Under the Contract Law, the continuing performance will primarily apply to monetary obligation, and will also be available to non-monetary obligation but subject to certain limitations. The monetary obligation, by definition, is the obligation that seeks for, or could be satisfied with, the payment of certain amount of money. Since there are different requirements for the continuing performance under the Contract Law with regard to these two kinds of obligations, we now discuss them separately.

4.1.1. *Monetary Obligation*

The continuing performance for monetary obligation is provided in Article 109 of the Contract Law. Under Article 109, if one party to a contract fails to pay the money for purchase or remuneration, the other party may request the party to make the payment.[22] The language of Article 109 is clear, that is, in case of breach of the contract that involves the monetary payment, it will be up to the aggrieved party whether to demand the party in breach to continue performing the contract.

There are two issues that have been raised in the application of Article 109. One issue is whether the monetary obligation may be exempted or whether the party in breach may have any defense against monetary claim. In general, the monetary obligation may not be exempted because of the highly fungible nature of the money. But the question is whether the monetary obligation may be exempted for the reason of *force majeure*. There is no readily answer in Article 109. In practice, however, the *force majeure* is not an acceptable reason for the exemption of monetary obligation since the lack of money will not render the performance of monetary obligation objectively impossible and the difficulty in paying money could be overcome through other payment alternatives such as installments or extension of payment period.

The other issue is whether the aggrieved party is entitled to other remedies when making request for continuing performance of monetary obligation. It has been generally held that the continuing performance and other types of remedies are not mutually exclusive, and thus the aggrieved party is not deprived of other remedies when seeking for continuing performance.

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[21] According to Article 9 of the Arbitration Law, if after an arbitration award has been made on the dispute a party brings an action in a people's court for the same dispute, the people's court shall not take the case. If, however, an arbitration award is set aside by the people's court, a party may initiate a lawsuit in a people's court.

[22] See the Contract Law, art. 109.

To illustrate, assume that A and B has a contract by which A will deliver to B 1000 cases of brand beers and B will pay A RMB 150,000 (about US$ 18,160) upon receipt of the delivery. Assume also that according to the contract, whoever is in breach of the contract will be liable for stipulated damages of 10% of the contract price. After the beers are delivered B defaults in making the payment. Under Article 109, A may request B to continue performing the contract (namely to make payment to A), and in the meantime, A will also be entitled to the stipulated damages as well as the accrued interest between the date of payment due and the date of actual payment.

4.1.2. *Non-Monetary Obligation*

The continuing performance as applied to non-monetary obligation is a little more complicated. On the one hand, the continuing performance is available to non-monetary obligation particularly when money damage is deemed as inadequate. On the other hand, a significant amount of non-monetary obligations are replaceable on the market, which would make the continuing performance meaningless. In addition, there are certain kinds of non-monetary obligations that are not suitable for continuing performance, most of which are in the service areas. Consequently, as far as the non-monetary obligations are concerned, the availability of the continuing performance is always legally restricted.

Given this complexity, the Contract Law has the different rules that apply to the continuing performance for non-monetary obligation. Under Article 110 of the Contract Law, if one party to a contract fails to perform the non-monetary debt or the performance of the non-monetary debt fails to satisfy the terms of the contract, the other party may request the party in breach to perform, subject to certain exceptions.

Article 110 further provides that in any of the following situations, the request for continuing performance of non-monetary obligations will not be granted: (a) the performance cannot be made as a matter of law or as a matter of fact; (b) the subject matter of the obligation is unfit for compulsory performance or the expenses for the performance are excessively high; or (c) the creditor does not make the request for performance within a reasonable period of time.[23]

Thus, pursuant to the Contract Law, in order to have the remedy of continuing performance of non-monetary obligation, there must be a non-performance or non-conforming performance of the non-monetary obligation provided in a valid and enforceable contract, and there must exist no circumstances under

[23] See the Contract Law, art. 110.

which the continuing performance is not available. In fact, Article 110 sets forth three basic rules that govern the availability of the continuing performance for non-monetary obligation. These three rules are the impossibility rule, the impracticability rule and the time rule.

Impossibility Rule

The rule of impossibility applies when the continuing performance is rendered impossible either by law or by fact. Hence, with respect to continuing performance, the impossibility can be further divided into legal impossibility and factual impossibility. The legal impossibility means that for certain non-monetary obligations the continuing performance is prohibited or rejected by law. A common example that has often been used to illustrate legal impossibility is that the subject matter of the contract becomes illegal due to the change of law or regulations. Another example concerns the obligor who is in bankruptcy. In the bankruptcy case, to permit the continuing performance may jeopardize other creditors' rights and then destruct the purpose of bankruptcy law.

Also an example is the transaction that involves a good faith third party purchaser for value. Assume A contracts to sell an antique to B for RMB 10,000 (US$1,250). Before the delivery day, A sells the antique for RMB 15,000 (US$ 1,820) to C who has no knowledge of the contract between A and B. C is the purchaser in good faith. Since the law will generally protect the interest of the third party purchaser in good faith, it would be legally impossible for A to make continuing performance by retreating the antique from C and selling it to B under the contract. Note that there is no such a provision as purchaser in good faith currently in Chinese law, but in practice there is a well-received rule that "a good faith purchaser for value has the right to refuse to return the item purchased".[24]

The factual impossibility refers to the situation where the contract could not possibly be performed when viewed objectively, no matter what efforts the obligor may make to try to perform. A good example in this regard is the contract for sale of specific goods. Because of the unique nature, the specific goods are normally not fungible in the market, and therefore the continuing performance will help protect the interest of the obligee by urging the obligor to perform. However, if the specific goods are lost or destroyed, e.g. by fire, there is no way to have the specific goods replaced or restored. Thus in case of the loss of specific goods, it will be factually impossible for the obligor to

[24] See Xing Ying, *supra* note 1 at p. 131.

make any continuing performance even thought the loss was caused by the fault of the obligor. As a result, the continuing performance will not be available.

Practically, in case where the obligee may not request for continuing performance when the specific goods in question are lost, the obligee may alternatively ask for damages. In fact, this alternative has been accepted and employed by the people's courts. In its Rules for the Matters Concerning the Work on the Enforcement of Judgments of the People's Courts (1998), the Supreme People's Court specially addressed the damages as an alternative to the continuing performance.

According to the Supreme People's Court, if the effective judgment has a clear indication what is subject to enforcement is a specific thing, the delivery of the original of the thing should be enforced. If the original has been concealed or illegally transferred, the court has the right to order the obligor to turn it in. If it is certain that the original has been deteriorated in quality, damaged or lost, the court shall order a damage equal to the converted value of the original or apply the damage against the obligor's other property equivalent to the value of the original.[25]

Impracticability Rule

The continuing performance may become impracticable either because of the unique nature of contract or because of prohibitively high costs. The contracts that are considered as unsuitable for the continuing performance are normally those that are formed on the basis of personal relationship or personal trust (or credibility). A partnership contract, for example, is strongly dependent on the personality of the partners, and therefore may not be proper for continuing performance. In China, the contracts such as contracts for work or contracts for entrustment are regarded as relying on the person of the obligor, and then unfit for the continuing performance due to the personal nature of the obligation of such contracts. Also for the contract involving personal service, the continuing performance is not suitable because of the law or policy against any restriction on personal liberty by contract.

Surely, the unfitness mainly involves the person of the obligor. But the concern about the costs is basically the consideration of economic efficiency for the continuing performance. The idea is that a contract represents a balanced interest between the contractual parties, and the duty of one party to honor the contract is to ensure the other party to get what is expected from the bargain.

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[25] See Supreme People's Court, *1998 Rules for the Matters Concerning the Work on the Enforcement of Judgments of the People's Courts*, art. 57.

If in case of breach, however, the party in breach ends up with paying much more than what ought to be paid as compensation to the aggrieved party, the interest balance between the parties will be destroyed – a result that is highly undesirable. The very purpose of the economic efficiency is to help protect the party in breach from burdening the liabilities that are unnecessary and excessive.

As applied to the continuing performance, the economic efficiency doctrine makes it impractical for the breaching party to fulfill the obligation to perform the contract if the performance is too expensive to be carried out. The test to ascertain whether the expenses of performance are excessively high is whether the cost of performance and the benefit conveyed are unreasonably disproportionate. It is also suggested in the court practices that if the loss of the obligee could be adequately compensated through monetary remedies such as damages or pecuniary awards, it would be deemed as excessively high in terms of expenses to compel a continuing performance.[26]

Some argue that the impracticability rule shall be applied as well to the case where the time period that the continuing performance would take will be excessively long. This argument actually focuses on the role of the court in enforcing the continuing performance. Their point is that the continuing performance is a legal remedy granted by the court according to law, and to enforce the continuing performance the court's intervention by way of supervision would be needed. If the continuing performance takes a long time, it might become impractical because an undue investment of judicial time and effort will be involved on the one hand, and the court may face difficulty of supervision on the other.[27] At the present, however, the difficulty of court supervision has not been taken into account in the Contract Law with respect to the continuing performance.

Time Rule

The time rule is relatively straightforward. Continuing performance may not be granted without the request of the aggrieved party, but such a request must be made within a reasonable period of time after the breach of the contract by the other party, or otherwise the right to make the request will be deemed as waived or lost. The time rule has a two-fold role: to help avoid undue difficulty the party in breach may face and to help maintain a rational relation

[26] This is the suggestion from the judges in the Supreme People's Court. See Li Guoguang, supra note 5 at p. 438.

[27] See Wang Liming, supra note 4 at p. 579.

between the players of business transactions. But there is no simple test for "the reasonable period of time", and the reasonableness would need to be determined on a case-by-case basis in light of the nature or character of the particular contract.

Some in China point out that the time rule should also include a "grace period" for the party in breach to perform. It means that when making a request for continuing performance, the aggrieved party shall give the party in breach a reasonable period to complete the performance, and only if the party in breach fails or refuses to perform after the reasonable period, the aggrieved party may ask the court to compel.[28] The proponents of the "grace period" obviously are trying to take into account the reasonable effort of the party who is requested to continue performing the contract.

As an alternative, the aggrieved party may dissolve the contract and ask for damages in lieu of the continuing performance. But a drawback is seemingly that when the contract is dissolved, the remedy of continuing performance no longer exists. An obviously logical reason is that the dissolution and continuing performance are mutually exclusive.

Another view concerning the time rule suggests that if the parties to a contract provide in their agreement a time period for the aggrieved party to make request for continuing performance, such a time period should be followed. However, if the parties instead provide that in case of breach, the aggrieved party may only ask the party in breach to pay damages or bear liability for compensation, and may not request continuing performance, their agreement as such prohibiting continuing performance would in general be held valid and effective.[29] The reason supporting this view is that if the parties agree not to pursue continuing performance in case of breach, the right of the aggrieved party to the continuing performance is thereby waived through their agreement.

4.2. Remedial Measures

Remedial measures are the remedies provided by the Contract Law between specific performance and damages, and they are the measures that are purposed to cure the defects in the performance and in the meantime to prevent

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[28] See Sun Lihai, *A Practical Explanation to the Contract Law of China*, 174 (Industry and Commerce Publishing House, 1999). Many, however, disagree because they believe that Article 110 only sets a time limitation for the aggrieved party to exercise the right to make a request for continuing performance, and does not require the aggrieved party to give the party in breach more time to prepare for the performance after the request for continuing performance is made. On the other hand, since the party in breach is already at fault in not performing the contract, it should not be entitled to more time to make the performance.

[29] See Li Guoguang, *supra* note 5 at p. 439.

further losses or damages that may incur in the breach of contract. Under the Contract Law, the measures that are remedial mainly include repair, replacement, reworking, returning of goods, or reduction of price or remuneration. Because of their function of curing the defective performance, the remedial measures mostly apply to non-conforming performance or the performance that does not meet the standard, specification or terms as agreed upon by the parties to the contract.

The major provision concerning remedial measures is Article 111 of the Contract Law. Under Article 111, the aggrieved party may seek remedial measures from the other party when there is no agreement between the parties on liability for non-conforming quality of performance or such agreement is unclear, nor can the liability be determined by supplement agreement, contract provisions, or transaction practices.[30] Although Article 111 mainly deals with defective performance in quality, the remedial measures may also include continuing performance when non-conforming performance is involved. As a matter of fact, some of the remedial measures such as repair, replacement, and reworking are themselves sort of continuing performance because they are aimed at having the contract performed as agreed upon by the parties.

Returning of goods actually means a unilateral dissolution of the contract, and thus its application is necessarily restricted to the case where the defects in the quality of the goods are so serious that the purpose of the contract will not be properly served. As noted, under Article 94 (d), a contract may be dissolved if one party to the contract defaults in performing its contractual obligations or breaches the contract by other conducts so that the purpose of the contract could not be realized.

Reduction of price or remuneration is an alternative to the returning of goods, particularly when the aggrieved party has received the defective goods and such defects may not necessarily frustrate the purpose of the contract. When the aggrieved party chooses the price reduction, the reduced amount shall be the difference between the contract price and the price the defective goods may actually be worth. After the aggrieved party accepts the defective performance at a reduced price, the performance shall be deemed as complete.

Again, the remedial measures also may not preclude the liability of the party in breach for other damages caused to the aggrieved party as a result of the breach. In addition, if there are any costs associated with the remedial measures, the party in breach shall generally be held liable for such costs. It should be noted that under the Contract Law, if there is an agreement between the parties, or there exists transaction practice, that governs the non-conforming

[30] See the Contract Law, art. 111.

performance, the remedial measures should not be applied. Also, in order to make the remedial measures meaningful, it is important that defective performance is remediable and the party in breach has the ability to take the remedial measures.

4.3. Damages

Damages are generally the monetary remedy to compensate the loss that the aggrieved party suffers from the breach.[31] Compared with other remedies in the Contract Law, the damages have at least two unique distinctions. The first distinction is the general nature of application. Damages are applicable to any case where other remedies are not suitable, available or adequate.

The second distinction rests with the supplementary function of damages. Damages may always be used to fill the gap left by other remedies or to supplement the loss that could not be covered by other remedies. Thus, according to Article 112 of the Contract Law, if one party to a contract fails to perform the contract or its performance fails to satisfy the terms of the contract, and if the aggrieved party has suffered other loss, the party in breach, after performing his obligations or taking other remedial measures, shall compensate for the loss.[32]

As far as award of damages is concerned, the scope of damages and causation are the two major issues that have been heavily debated in China. The scope of damages involves two sub-issues. One sub-issue is whether the damages in contractual contexts should be limited to property damage or shall also include personal damages (e.g. mental distress). Many view that the damages under the Contract Law only refer to property damages or economic loss of the aggrieved party because the personal damages are almost impossible to be predicted at the time of contract and also are difficult to be valued in certain money amount. Therefore, the non-property damages such as personal or emotional damages that are caused as a result of breach of the contract may only be dealt with separately under different cause of action.[33]

A different view emphasizes the interests of the aggrieved party by arguing that it should allow the aggrieved party to choose to seek personal damages in

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[31] In certain cases, the damages may take the form of "in kind". But if the "in kind" damages are awarded, they are must be something different from the subject matter of the contract, or otherwise, the "in kind" would not be the damages, but continuing performance.

[32] A similar provision can be seen in the 1986 Civil Code. Article 111 of the Civil Code provides that if a party fails to perform its contractual obligations or the performance violates the terms of the contract, the other party shall have the right to demand the performance or remedial measures, and shall also have the right to claim compensation for damages.

[33] See Xing Ying, *supra* note 1 at pp. 151–152.

a contract claim if such damages could be quantified in certain amount of money.[34] The theoretical basis of this view is to treat the personal damages deriving from the breach of the contract as the combined claim of both contract and torts, in which the aggrieved party may choose to sue either under the cause of action of contract or the cause of action of torts.[35]

The second view above has its reflection in the Contract Law. Under Article 122, if the breach of contract by one party infringes upon the other party's personal or property rights, the aggrieved party shall be entitled to choose to ask the party in breach to bear liability for breach under this law or to seek torts liability against the party in breach in accordance with other laws.[36] The Supreme People's Court takes an even more flexible approach in dealing with this situation. According to the Supreme People's Court, if the aggrieved party requests to change or modify the cause of action after a choice is made in pursuit of Article 122 of the Contract Law but before the first instance trial at court begins, the request shall be granted.[37]

The other sub-issue deals with what damages beyond the direct loss of the aggrieved party should be included. In China, it is common to divide the loss into direct loss and indirect loss, but what seems always questionable is what may constitute indirect loss. The difficult part of the question involves the interest to which the aggrieved party is entitled from the contract. In common law system, such interests are further categorized as expectancy interest, reliance interest as well as restitution interest.[38] In China, however, only expectancy interest seems to have been well accepted. Therefore, contractual damages in China generally include direct loss and expected benefits (interests).

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[34] See Wang Liming, *supra* note 4 at p. 599.

[35] The combined claim of both contract and torts refers to the claim arising out of the incident or conduct that concurrently violates the law of contract and the law of tort, which results in the concurrence of contract obligation and tort liability.

[36] The Contract Law provides no guideline for the parties to make a choice in case where both contract claim and tort claim concur. A scholarly suggestion is the test of interest. Under this test, if the personal interest of the aggrieved party is infringed in the breach of contract, a tort action may be preferred because the remedy for personal damage is not available in a contract action. If, however, the interest in performance of the contract is the priority of the aggrieved party, a contract action should be chosen. See Xing Ying, supra note 1 at pp 281–285. Others also suggest that if the parties agreed in advance not to make any claim other than contract claim in case of concurrence of different causes of action, the agreement should be upheld. If however, there is special provision of law purposed to reduce the duty of care of the party, such provision shall also be followed. See Sun Lihai, *Selection of Legislative Materials of the Contract Law of China*, 168–169 (Law Press, 1999).

[37] See Supreme People's Court, *Explanation to the Questions Concerning Implementation and Application of the Contract Law of the People's Republic of China (I),* 1999, art. 30.

[38] See Calamari & Perillo, *The Law of Contract* (*4th ed*), 545 (West Group, 1998).

The issue of causation concerns the relationship between the fact of breach of contract and the loss. To ascertain the causation, the Contract Law follows the rule of foreseeability, which requires that the damages should only be awarded if they are the probable consequences of the breach and such consequences are foreseeable by the parties at the time of contract. From many Chinese contract scholars' viewpoint, the rule of foreseeability essentially functions as a gauge to help keep the damages within certain boundary. Under the rule, the causation would exist when the damages that are caused by the breach are foreseeable, and the party in breach is only responsible for the damages that could be reasonably foreseen.

There is no readily test in the Contract Law to determine the foreseeability. Normally, to claim damages for breach of contract, what the aggrieved party would be asked to prove are the fact of breach, the loss, and the connection between the breach and the loss. It then is up to the court as to what damages are foreseeable. The standard generally used is whether the damages are the reasonable and natural outcomes of the breach that would be contemplated by an ordinary person in the same or similar situation at the time of contract. If, however, the aggrieved party wants to ask more, it must be proved that there is additional damage that is foreseeable under the special circumstances known to the parties.

It should be mentioned that the almost all contract law scholars in China are in favor of a damage principle called "full compensation". The full compensation means that in case of breach of contract, the party in breach shall be responsible for all damages that have been caused to the aggrieved party. They view that only when the compensation is fully made, the aggrieved party may be well restored to the position that he would be if there had been no breach. Thus, by requiring that the party in breach compensate the aggrieved party for both the direct damages and expectation interests, the Contract Law is said to have adopted the principle of "full compensation".

For purposes of discussion, there are four different kinds of damages that are available under the Contract Law, namely compensatory damage, liquidated damage, punitive damage, and earnest money. But as we indicated at the beginning of this chapter, because the Contract Law is in favor of compensatory nature of remedies, the punitive damage only deals with very special cases as stipulated by laws and administrative regulations.

4.3.1. *Compensatory Damages*

The most significant damages provided in the Contract Law are compensatory damages. Damages are deemed as compensatory if their purpose is to place the aggrieve party in the same position as the aggrieved party would be if the contract had been performed as agreed upon by the parties. According to

Article 113, the party in breach shall be liable for damages that are caused to the aggrieved party by his failure to perform the contractual obligations or by his non-conforming performance. The amount of damages shall be equal to the loss caused by the beach of contract, including the interests that would be expected to obtain if the contract is to be performed.[39]

Apparently, Article 113 is the basic law of the damages of compensatory nature. Under Article 113, in breach of contract, the aggrieved party may recover from the party in breach the actual losses and the benefits that are expected. In the meantime, however, Article 113 sets forth a ceiling that limits the compensatory damages to the amount not exceeding the probable loss, caused by the breach of contract, that had been foreseen or should have been foreseen when the contract was made. Clearly, the determination of both actual loss and expectation interest is subject to the rule of foreseeability.[40]

There are some cases in which both parties to a contract may each have breached the contract, or there is an occurrence of so-called "mutual breach". The Contract Law does contain a special provision that governs the mutual breach. Article 120 of the Contract Law provides that if both parties breach a contract, they shall bear the liabilities respectively. If the liabilities are the same kind in nature (e.g. money payment), they might be set off to the same amount that is mutually owed.[41]

4.3.2. *Liquidated Damages*

The parties to a contract may negotiate in their contract a certain amount of damages that the party who breaches the contract should pay as the compensation to the aggrieved party. The damages so provided are termed as liquidated damages or stipulated damages. One major character of the liquidated damages is that the damages are provided in advance and take effect when the breach occurs. Another unique nature of the liquidated damages is that the damages are not determined on the basis of actual loss but on the estimation of the loss by the parties through their agreement. The liquidated damages may be made in the form of specific amount of money or in the form of a particular formula by which the damages will be calculated.

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[39] See the Contract Law, art. 113.

[40] Article 113's limitation on compensatory damages is consistent with Article 74 of the 1980 UN Convention on International Sale of Goods. Under Article 74, damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or out to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.

[41] See the Contract Law, art. 120.

Under Article 114 of the Contract Law, the parties to a contract may agree that one party, when breaching the contract, shall pay the stipulated damages of certain amount in light of breach, or may agree upon the calculating method of damages resulting from the breach of contract.[42] Article 114 does not define the liquidated damages, it nevertheless recognizes that there are two forms for providing the liquidated damages, namely the agreement on the amount of stipulated damages or the agreement on the methods by which the damages are to be calculated. Also it should be pointed out that the liquidated damages are provided in the Contract Law as a type of liability for breach and the parties may choose to provide it as they wish, though some believe that the liquidated damages are actually the guarantee for the performance of the contract.

Basically, the liquidated damages are compensatory as to the aggrieved party. But the question is whether the liquidated damages may constitute a penalty against the party in breach. In contrast with the US law under which a measure of damages that appears to be punitive will not be enforced, the liquidated damages in China are regarded to possess a punitive nature, which can been discerned from several respects. First of all, the general understanding in China is that an important function of the liquidated damages is to deter the breach, which would make it a known rule that whoever fails to perform contract has to face economic punishment. Secondly, the court or arbitration body may not set aside the liquidated damages without request of the interested party. Thirdly, the liquidated damages may not be the only damages that can be recovered.

This proposition is clearly underscored in Article 114. On the one hand, Article 114 further provides that if the agreed amount of damages turns out to be lower than the loss actually caused, the aggrieved party may request a court or arbitration body to increase it. On the other hand, Article 114 allows the party in breach to ask a court or arbitration body to reduce the amount of liquidated damages if the amount is proved to be excessively higher than the actual loss. Furthermore Article 114 make it mandatory that if the liquidated damages are agreed in respect to the delay in performance, the party in breach should still be obligated to continue performing its obligations after the liquidated damages are paid.[43]

Thus, under the Contract Law, the liquidated damages that appear to be punitive will not necessarily become void. It, however, should not be concluded that

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[42] See *id*., art. 114.

[43] In China, many agree that in general, the liquidated damages may become a substitute of the continuing performance. Only in case where the performance is delayed, the aggrieved party may ask for continuing performance after receipt of the liquidated damages.

the Contract Law sets no boundary to limit the liquidated damages of punitive nature. On the contrary, the underpinnings of Article 114 is that the liquidated damages shall be made on a reasonable basis reflecting an honest effort by the parties to stipulate the damages that would be the likely result of a breach.

But in order to attack the liquidated damages on the ground of unreasonableness, a party must make a request as such to a court or arbitration body. If the amount of the liquidated damages is found unreasonable, the court or arbitration body will generally grant an adjustment to the amount, not simply avoid it. Note that the reasonableness applies to both the amount of liquidated damages that is too low and the amount that is excessively high.

4.3.3. *Punitive Damages*

Punitive Damages are the damages aimed only at punishing the party in breach, and the amount of such damages is usually much higher than the actual loss that has incurred to the aggrieved party. In many countries, punitive damages are not available in contract actions no matter how serious the breach is. In China, the award of punitive damages, though not eliminated, is also strictly limited as applied in contracts. In the Contract Law, the imposition of punitive damages is provided in Article 113 which requires a cross reference to other law and also mandates that the punitive damages deal primarily with the fraudulent activities committed in business operations.[44]

The direct cross reference indicated in the provision of Article 113 with regard to punitive damages is the Law of Protection of Consumers' Rights and Interests (Consumers Protection Law), which was promulgated on October 31, 1993 and took effect on January 1, 1994. In accordance with Article 49 of the Consumers Protection Law, if the business operators are found to have committed fraudulent conducts in providing goods or services, the damages for loss so caused to consumers shall be multiplied on the demand of the consumers. The increased amount of damages shall be equal to the double amount of price of the goods purchased or the service received.

4.3.4. *Earnest Money*

Under the Contract Law, the parties to a contract may agree to provide a sum of money as security to guarantee the performance of the contract. Because of its security function, the sum is commonly labeled as earnest money. The amount of earnest money is normally a certain percentage of the contract price, and is made after formation and before performance of the contract. In China, the earnest money is used mainly to compensate the aggrieved party in

[44] See the Contract Law, art. 113.

case of breach, and is paid by one party to the other as agreed. As implicated in the Contract Law, the earnest money is a security for performance and in the meantime a liability for breach.

Prior to adoption of the Contract Law, earnest money was provided in both the 1986 Civil Code and the 1995 Guaranty Law of China as a type of the security to guarantee the creditor's rights. The Contract Law makes the earnest money a remedy for breach of the contract. Under Article 115 of the Contract Law, the parties to a contract may, in accordance with the provisions of Guaranty Law, agree that one party pays earnest money as a guarantee of performance to the other. The earnest money so paid shall be refunded or offset against the contract price after the contract obligations are performed.[45]

Article 115 also stipulates a rule under which the earnest money is to be used against the non-performance by any of the parties. If the payer of the earnest money fails to perform the agreed obligation, he shall have no right to reclaim the money paid. However, if the payee of the earnest money fails to perform its obligations, he is required to double refund the money being paid.[46]

Obviously, the earnest money as used to secure the performance of contract under the Contract Law has a punitive nature. For the payer of the earnest money, failure to perform will result in the forfeiture of the earnest money. As far as the recipient of the earnest money is concerned, his breach of contract will lead to a penalty of paying twice as much as the earnest money received.

More importantly, the earnest money may not be employed to replace damages. Thus, in the event of breach, the aggrieved party may not only keep the earnest money, but also demand the party in breach to continue performing the contract. Similarly, the aggrieved party may seek damages in addition to the earnest money if there is any loss resulting from the reach.

However, in order to avoid double jeopardy to the party in breach, the Contract Law prohibits the aggrieved party from claiming both liquidated damages and earnest money. Under Article 116 of the Contract Law, if the parties to a contract have agreed on both liquidated damages and earnest money, the aggrieved party may only choose to take either liquidated damages or earnest money if the other party is in breach of the contract. Therefore, it is permissible that the parties provide in their contract both liquidated damages

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[45] See *id*., art. 115.

[46] A similar provision is Article 89 (3) of the 1986 Civil Code. Under Article 89 (3), subject to the limits provided by the law, a party may pay the other party the earnest money. After the contractual obligations are performed, the earnest money provided may either be used as partial payment of the contract price or be refunded. If the paying party defaults in his performance, he shall not be entitled to demand the refund of the earnest money. If the receiving party fails to perform, he shall double repay the earnest money.

and earnest money, but the aggrieved party may only claim one of them when the other party breaches the contract.

There is a writing requirement for an agreement on the earnest money. According to Article 90 of the Guaranty Law, the earnest money agreement shall be made in writing. With regard to the delivery of the earnest money, the parties are required to specify in their agreement the time for the delivery, and the agreement will not take effect until the day when the earnest money is actually delivered. Because of the security function of the earnest money, the agreement of the earnest money is normally regarded as a side contract, although such an agreement is often seen as a contract clause or article. The existence of such agreement is totally dependent on the underlying contract.

An issue that recurs with high frequency is perhaps the amount of the earnest money. The parties, of course, have the right to decide through their negotiations how much the earnest money should be on the basis of the contract price. But in order to prevent abuse of the right, there is a cap that is imposed by the law. In accordance with the Guaranty Law, the maximum amount of the earnest money as agreed upon by the parties shall not exceed 20 percent of the contract price. In practice, if the agreed earnest money is over the 20 percent cap, the agreement will not necessarily be void, but the agreed amount will be reduced to the 20 percent.

5. Mitigation Duty

Mitigation, also called "avoidable consequence", is the rule to preclude the recovery of the damages that could have been avoided with reasonable efforts and without undue risk, burden or humiliation.[47] The duty to mitigate is recognized in the Contract Law and applies to the aggrieved party. The idea is that in case of breach the aggrieved party shall not sit idly and allow the damages to accumulate. In China, the mitigation duty is viewed as a fault-based duty, under which the aggrieved party will be found at fault if it fails to take reasonable action to avoid further damages that could be avoided.

The mitigation duty is provided in Article 119 of the Contract Law. It is required that the non-breaching party take proper measures to prevent the aggravation of loss. If the non-breaching party fails to take proper measures so that the loss is aggravated, it may not claim any compensation as to aggravated part of the loss.[48] In addition, the party in breach will be held responsible for the reasonable expenses incurred to the other party for making efforts

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[47] See Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 Va. L. Rev. 967 (1983).

[48] See the Contract Law, art. 119.

to prevent the loss aggravation. But according to the people's courts, the reasonable expenses should not include the salaries or other remuneration for the services of the party.[49]

Under the Contract Law, the mitigation duty also arises in the situation where the contract could not be performed due to *force majeure*. Article 118 provides that a party who is unable to perform the contract on the ground of *force majeure* shall give the other party a prompt notice in order to reduce the probable loss to the other party, and shall provide evidence in this regard within a reasonable period of time.[50] To simplify, the duty of mitigation, as applied in Article 118, is about the duty of prompt notice.

6. Exemption of Liability

Once again, based on the traditional doctrine of *pacta sunt servanda* (agreement must be kept), a party who fails to perform a contract shall be held liable for breach. But such liability may be excused in certain circumstances that are either agreed by the parties or provided by the law. If a party is exculpated from the liability for breach under the agreed circumstances, the exculpation is called contractual exemption. When the liability for breach is excused under the provision of law, the exculpation is termed as legal exemption. If the breach falls within the legal exemption, the liability of the party in breach will be excused as the operation of law without reference to the agreement of the parties or the terms of the contract.

The only legal exemption of the contractual liability in the Contract Law is the exemption on the ground of *force majeure.* Under Article 117 of the Contract Law, in case where a contract could not be performed because of *force majeure*, the liability for breach shall be excused in part or wholly in light of the effects of the *force majeure*. Recall that in Article 94 of the Contract Law, the *force majeure* is a legal ground on which a contract may be dissolved. Here upon occurrence of *force majeure*, a party's obligation to perform the contract will be excused and the liability for breach will consequently be exempted.

In the meantime, Article 117 provides two exceptions to the legal exemption, namely exemption from the liability due to *force majeure*, under the Contract Law. The first exception is where "the law otherwise provides". For example, under Article 34 of the Post Law, *force majeure* may not exempt the liability of the post office for the loss of money remittance or insured postal articles. The second exception involves delayed performance. It is provided in

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[49] See Li Guoguang, *supra* note 5 at p. 497.

[50] See the Contract Law, art. 118.

Article 117 of the Contract Law that if the *force majeure* occurs after one party has delayed in performance, the liability shall not be exempted. The underlying reason is that delay in performance is a breach for which the non-performing party should be held liable, and *force majeure* should not exempt the liability of the party who is already in breach.

Quite often, parties to a contract prefer to negotiate in their contract a *force majeure* clause in order to better protect their respective interests. Note that in China, absence of the *force majeure* clause does not deprive a party of the right to claim exemption upon occurrence of *force majeure* because of the availability of Article 117 legal exemption. But, if there is a *force majeure* clause in the contract, the clause will be regarded as a supplement to the legal exemption and may be used to help allocate risks and ascertain the scope or coverage of the *force majeure*.

Chapter XI
Third Parties

Third parties are those who are not the parties but related to the contract or have the interests in the contract. A broader coverage of the third parties also includes those who have impacts on the performance of the contract. There is a dictum in the contract literature that a contract has the effect or produces consequences only to the parties themselves and does not externally affect others.[1] But third parties theory penetrates the internality of the contract affairs and brings the non-party's interests into the center of discussion by looking at external effects created by the contract.

In China, an interesting phenomenon is that the matter on third parties seems to have not received as much attention as it should. Firstly, the Contract Law contains no special chapter dealing with third parties and the law of third parties can only be seen from the scattered provisions of the Contract Law. Secondly, almost none of the published contract books makes the third parties a separate issue and discusses them in a specific way. Thirdly, there is a lack of systematical rules that govern the relations between the parties and non-parties. The reasons for this phenomenon may be many, but the most important one appears to be rooted in traditional belief that a contract only involves the parties.[2]

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[1] See Robert Scott & Jody Kraus, *Contract Law and Theory (3rd ed)*, 1127 (LexisNexis, 2002).

[2] A predominant doctrine in China that precludes non-parties from the contract is the relativism of contract. Under this doctrine, only the parties may each other claim the rights and bear obligations arising from the contract. In this sense, relativism may actually mean or bear a great resemblance to "privity", though the term "privity" is not commonly used in China.

Before the Contract Law was adopted, the matters of third parties in China only appeared in conjunction with the assignment. At that time, a popular notion was that the contract was the matter of parties, and the only possible non-party who may affect the contract was government authority. Therefore, the concerns about non-party were all centered on the authority coming from the government, and there were certain legal provisions that applied in this respect. An illustrative example is Article 116 of the 1986 Civil Code. It provides that if a party fails to fulfill its contractual obligations on account of the higher authority, the party shall first compensate the other party for damages or take other remedial measures as agreed upon in the contract, and then the higher authority shall be responsible for settling the loss the party suffered.

The Contract Law expands the third parties to include those to or by whom a contract is performed. In addition, the Contract Law replaces the term "government authority" with the term "third parties" to cover in a more general sense the situation where the non-performance is caused externally by a non-party (including government authority). However, it must be noted that the Contract Law contains no such concepts as intended or incidental beneficiary nor does it differentiate donee beneficiary from creditor one. In other words, the Contract Law makes no further efforts in the identification of the third parties.

Nevertheless, compared with previous laws, the Contract Law has made certain progress in regulating third parties. In addition to assignment, the Contract Law specifies several situations in which a third party is involved. The first situation is the contract whereby the parties agree to make performance to a third party. The second situation concerns the contract under which the performance is to be made by a third party. The third situation deals with the breach that is caused by a third party. In addition, the Contract Law has several provisions that are aimed particularly at protecting the interests of the third parties. For instance, according to Article 106 of the Contract Law, the rights and obligations of a contract may not be terminated as a result of the assumption of the rights and obligations by the same person if the interests of a third party are involved. But still, the matter of the third parties is an unfinished business of the Contract Law.

It is true that the issues concerning the third parties could not be fully addressed without discussing assignment and delegation because an assignment or delegation involves a transfer of contractual right or obligations from a party to a non-party. But is should be pointed out that in China, assignment and delegation normally come up with the modification of contracts. A common belief in China is that assignment and delegation are more closely related to the modification than to the third parties. This belief, as we have seen, is also reflected in the Contract Law where the contract assignment (including delegation) is provided in the chapter together with the contract modification.

1. Third Party Receiving Performance

Under the Contract Law, the parties to a contract may agree to have the contract to be performed to a third party. In China, the third party who is designated to receive performance is specified to consist of two kinds of person. One is the person upon whom the benefits of the contract will be conveyed through performance, and the other one is the person who will not be benefited by the performance but to receive the performance on behalf of the obligee for the benefit of the obligee. In the former situation, the third party is called the beneficiary, but in the latter case, the third party is actually an agent of the obligee for the purpose of receiving performance. Because of this distinction, a third party, in the sense of Chinese law, does not necessarily mean a third party beneficiary only.

According to Article 64 of the Contract Law, where the parties agree that the obligor performs the obligations to a third party, and the obligor fails to perform the obligations to the third party or the performance does not meet the terms of the contract, the obligor shall be liable to the obligee for the breach of contract. Three points could be inferred from Article 64. First, it is permissible that a contract is performed to a third party upon the agreement of the parties. Second, a contract to be performed to a third party is enforceable, and failure to perform constitutes the breach of contract. Third, in case of breach, the obligee remains to have the claim against the obligor for remedies.

However, Article 64 appears to invite confusion. In one respect, it is unclear whether the third party referred to in Article 64 includes both the third party "beneficiary" and the third party "agent" or only one of the two. In the other respect, the uncertainty is whether a third party has the right to demand the performance that the third party is supposed to receive. Some view that Article 64 is about third party beneficiary because it states the situation where the contract is made for the benefit of a third party.[3] Others insist that Article 64 actually refers only the third party "agent" who receives the performance for the benefit of the obligee. The reason underscoring this assertion is that the performance to a third party is based on the intent of the obligee and its purpose is to satisfy the contractual interest of the obligee.[4]

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[3] See Jiang Ping et al, *A detailed Explanation of the Contract Law of China*, 54 (China University of Political Science & Law Press, 1999). See also Cui Yunling, *A General View on Contract Law*, 164–165 (China University of People's Public Security Press, 2003).

[4] See Li Guoguang, *Explanation and Application of the Contract Law*, 282–283 (Xinhua Press, 1999).

It has been further argued that Article 64 should be interpreted to also include the situation of third party "agent" but whether the contract is made for the benefit of a third party depends on whether a right to the performance has been created for the third party. Supporters of this argument have offered a three-test guidance to help tell the third party "beneficiary" from the third party "agent". The first test is the creation of independent right to the third party. If the parties agree that the third party shall be entitled to the performance of the contract and thereby the third party has an independent claim against the obligor for the performance, then the third party shall be deemed as beneficiary. If however, the third party is only to help accept the performance from the obligor for the obligee, the third party is an "agent".

The second test focuses on the intention of the parties for the performance to a third party. When the performance is intended to be made to a third party and the right of the third party to the performance arises after formation of the contract, the third party is a beneficiary if the third party as such does not reject performance. But if the performance to a third party is only intended as a change of the "route" of the performance and the intended beneficiary is actually the obligee itself, the third party then is an "agent".

The third test concerns the obligation to perform. In case where the obligor is only responsible to the obligee, not to the third party, for performance, the third party is not the beneficiary because he will not be benefited by the performance. The theory is that as a beneficiary, the third party should also be the person to whom the obligor is obligated to perform the contract.[5]

But, from a majority viewpoint, Article 64 seemingly intimates an inclusion of both the third party beneficiary and third party agent. On the one hand, Article 64 requires that the performance to a third party be made on the basis of agreement of the parties. The agreement as such may embrace an intent of the parties (obligee in particular) to convey the benefit of the performance on the third party (beneficiary) or may just obligate the obligor to make performance to the obligee through the third party (agent). On the other hand, the language of Article 64 stating that the obligor shall be liable to the obligee for breach of the contract does not necessarily means that the obligor is not liable for the performance to the third party. Their major argument is that Article 64 would become meaningless if it is interpreted to exclude the third party's right to make a claim against the obligor in the event of breach.[6]

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[5] See Wang Liming, *Study on Contract Law*, 56–57 (People's University Press, 2003).

[6] See Li Guoguang, *supra* note 4 at p. 283. But according to a different view, one of the legal effects of performance to a third party under Article 64 is that the third party has the right to ask the obligor to perform and such right is granted by, and exercised on behalf of, the obligee. See Jiang Ping, *supra* note 3 at p. 54.

Therefore, under the majority opinion, the performance to a third party under Article 64 is in general believed to possess three distinctive features. First, the contract will not be performed to the obligee but to the third party because the obligee has agreed that the third party will be the recipient of the performance. Second, the third party acquires directly from the agreement of the parties the right to request the obligor for performance, and then both the obligee and the third party have the right to the performance. Third, the performance to a third party is not premised on the consent of the third party. In making the third party the recipient of the performance, the obligee does not have to obtain the third party's consent in advance.[7]

In case that the third party is the beneficiary of the contract, it is commonly held in China that the third party may choose to accept or refuse the performance. If the third party accepts, its right to request the obligor to perform is vested, and the right is a derivative one of the contractual right of the obligee. When the third party refuses to accept the performance, the obligor is still liable to the obligee for the performance because as a result of the refusal, the right to the performance will automatically be regained by the obligee.

There are two questions related to the agreed performance to a third party. The first question concerns the additional expenses that may incur in association with the performance to a third party. Generally, the performance to a third party shall not increase financial burden of the obligor or increase the level of difficulty in performing as compared with the performance directly made to the obligee. A well accepted rule is that any additional costs for the performance to a third party shall be born by the obligee or by the third party if the third party agrees.

The second question is whether the obligor may still make the performance to the obligee after the third party agrees to accept the performance. Seemingly, the answer to this question would depend on the type of the third party who receives the performance. If the third party beneficiary is involved, the performance may not be made to the obligee because by the contract the performance is agreed to be made to the third party. In this sense, the performance made to the obligee may not release the obligor's duty of performance to the third party, but the obligor may ask the obligee for redemption.[8] If however, the third party is simply the agent of the obligee for the purpose of receiving the performance from the obligor, the obligor may feel free to still make the performance directly to the obligee.

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[7] See Sun Lihai, *A Practical Explanation to the Contract Law of China*, 86–87 (Industry and Commerce Publishing House, 1999).

[8] See Li Guoguang, *supra* note 4 at pp. 283–284.

2. Third Party Performing the Contract

A well-established and classical maxim in the law of contract is that a contract may only bind the parties, and therefore, the parties are prohibited from creating obligations on a third party. But there is an exception in the case where the third party agrees to assume the obligations of the contract between the parties. As long as the third party consents to performing the contract, the effect of the contract will be extended to it. Literally, the assumption of the contractual obligations by a third party may take different forms: third party performance, delegation or novation.

In the contract theory, a delegation occurs when a contracting party (obligor-delegator) appoints a third party to render the performance to the obligee. By delegating its contractual duty, the obligor-delegator is transferring its obligations to the delegated third party (delegate) who will then assume the obligations and perform the contract although the obligor-delegator may still remain liable to the obligee.

A novation, as we have mentioned, is essentially a change of an original party to the contract to a new party with the consent of all parties involved. Typically, a novation will take place when the existing contract is replaced by a new one as a result of the change of party. In U.S. for example, a novation substitutes a new party and discharges one of the original parties to the contract by agreement of all parties.[9] Therefore, in a novation, because of the change of a party, mostly the obligor, a new contractual relationship is to be established between an original contractual party and a third party.

The third party performance, by Chinese definition, is different from delegation or novation in that the third party performance involves no transfer of debt or change of party but only a substitute of obligor for the performance of the contract. The substitute of obligor means that a third party agrees to render the performance of the contract to the obligee on behalf of the obligor. The substitute normally occurs when there is an agreement and contractual relationship between the obligor and the third party.

To illustrate, assume that A and B enter a contract under which A shall make a payment of RMB 20,000 to B, and in the meantime, A and C have an existing lease where C pay rents to A. When A and B agree that the payment of RMB 20,000 shall be made by C to B, then in terms of performance of the contract between A and B, C will be A's substitute. The reason why C agrees to make the payment is that the payment will offset the rents C will have to pay to A.

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[9] See Restatement of Contracts (2nd), § 280.

The substitute as such may also be found when a third party volunteers to offer the performance. The voluntary performance could be made with or without the knowledge of the obligor. For example, a father learns that his son owes certain amount of money to A, and the father then pays A for the money owed without telling his son. Clearly, the father's substitute in making the payment constitutes a voluntary performance with regard to the money his son owes to A, and the performance releases his son from being obligated to pay A.

But, there is a debate on the nature of voluntary performance by a third party. One view is that the third party voluntary performance creates a *de facto* donation. In the above case, for example, what the father did by paying his son's debt is actually a gift he made to his son. The other view regards the third party voluntary performance as a conduct of *netotiorum gestor* (voluntary service).[10]

The Contract Law adopts the concept of the third party performance or the substitute of obligor, but limits the substitute to the one arising from the agreement of the parties. The recognition of the substitute of obligor in the Contract Law stands on the notion that to allow a third party to substitute an obligor for performance would help facilitate multiple business transactions that are related among each other. In this context, to speak strictly, the substitute of obligor is an assumption of the obligation as in the sense of delegation because, as noted, the delegation will results in the transfer of debts. Therefore, some scholars in China prefer to call the third party who is designated to performs the contract as the "entrusted obligor" in order to differentiate it from the delegate.[11]

Under Article 65 of the Contract Law, where the parties agree that a third party performs the contract obligations to the obligee and if the third party fails to perform or the performance does not satisfy the terms of the contract, the obligor shall be liable to the obligee for the breach of contract. The provision of Article 65 indicates a number of factors essential to the third party performance. First, the third party performance is based on the consent of the parties to the contract. Second, the substitute of obligor does not need an agreement between the substitute and the obligee or between the substitute and the obligor though in many cases the substitute and obligor have some kind of relationship. Third, the third party, when making the performance, does not acquire the status of a party to the contract. Forth, the third party may refuse to perform, and the obligee has no claim against the third party. And fifth, the obligor remains liable to the obligee until its obligations are fully performed.

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[10] See Wang Liming, *supra* note 5 at p. 63.

[11] See Chu Yunling, *supra* note 3 at pp. 166–167.

The legal effect of the performance made by the third party or the substitute of obligor, if not defective, is deemed in China as the same as that of the performance rendered by the obligor. The practical importance of this matter could be specified in two aspects. In one aspect, the third party performance accepted by the obligee will serve to discharge the contract between the obligor and obligee as if the contract has been fully performed by the obligor. The other aspect is that when the parties agree to have the obligations performed by a third party, the obligee may not refuse to accept the third party performance without justified reason. If the third party encounters an unreasonable refusal of the obligee to accept the performance, the obligee may be held liable for the breach of contract resulting from the delay in acceptance of performance.

3. Breach Caused By Third Party

It is not uncommon that a contract is breached not because of the fault of either of the parties but due to the conduct of a third party. For example, A and B have a contract by which A will deliver to B a machine on a specified day, and C is the supplier of a major component of the machine. A fails to make the delivery of the machine on time because C did not provide A with the parts timely. Thus, A's breach of the contract with B is caused by C's failure to make the parts available at the required time. Another example that is typical in China is that a party breaches a contract as a result of conduct of government authority, most of which occurs when the party is asked to change production plan or to accommodate local needs.

As we have noted, Article 116 of the 1986 Civil Code is a special provision concerning the action of government authority affecting the contract. The Contract Law pretty much follows the footprint of the Civil Code in terms of separating the contract liability from other liability by requiring the party in breach to compensate the aggrieved party without citing the government action as an excuse. The only difference between the Contract Law and the Civil Code is that the Contract Law classifies the government in the same category as the third parties. According to Article 121 of the Contract Law, a party who breaches the contract due to the cause of a third party shall be liable for the breach of contract to the other party. And, the dispute between the party in breach and the third party shall be resolved separately pursuant to the law or the agreement between them.

The fundamental notion underlying Article 121 is the doctrine of relativism of contract. Under the relativism, a third party's conduct constitutes no breach of contract because the contract is only a matter between the contracting parties. But the relativism does not mean that the third party is free from any liability for its conduct that is the cause of the breach of a contract. On the contrary, the third party will be liable to the party in breach who is affected by the third

party in the performance of the contract the party in breach has with the aggrieved party.

Thus, the liability of the third party is to be dealt with separately and out of the contract between the parties. In this regard, Article 121 of the Contract Law is clear on two points: First, if a contract is breached due to the reason of a third party, the party in breach is liable for the breach and the aggrieved party may not make any claim against the third party. Second, the party in breach may seek redemption from the third party and if there is an agreement between the party in breach and the third party, the dispute over the redemption shall be settled according to the agreement.

In terms of causing to breach the contract, a third party may fall within different categories. In one category, the third party is a secondary performer of the contract. By secondary, it means that the third party is of assisting the performing party to perform the contract. For example, A and B have a contract that A will build a house for B. During the construction, A asks his friend C to help with the ground paving for the foundation of the house. C, however, mistakenly uses wrong materials for the paving, which causes the significant delay in completion of the housing. In this case, B may only sue A for damages under the contract, and C's mistake may not be A's excuse for the delay.

Another category involves the third party who is contracted by B to perform whole or part of B's contract with A. The most common third party in this regard is the subcontractor. Under Article 121 of the Contract Law, B remains liable to A for the breach of the contract that is caused by the subcontractor because the contract is made between A and B.

Also in the third party categories is the superior or parent company of a party to the contract. In China, prior to the economic reform that started in late 1970's, almost all companies/enterprises were owned or controlled by the state under the planned economy structure. A big part of the economic reform was to separate the State from the business operations by privatizing certain state owned enterprises (e.g. allowing private individuals to own shares of a state-owned enterprise) or granting more power to the state-owned enterprises and other business entities to run their businesses. But still, there are many cases in which the business operation of company/enterprise is heavily influenced, if not controlled, by governmental authorities who used to be the decision makers of those enterprises or entities.[12] A good example is the business

[12] In all state owned enterprises, although many of them have been converted into the corporation type business entities (either a company with limited liability or a company limited by shares), the business operations are somewhat under the control of the government through the appointment of top business executives (CEO or Chairman). For instance, in August 2004, the State Council appointed new ECOs of four major Chinese airlines (they are all companies by shares) to replace the old ones who were discharged for different reasons.

that involves local interests, operation of which, to a great extent, has to meet the need of local government or the taste of local officials.

Before the adoption of the 1986 Civil Code, when a contract had to be changed or the performance of the contract was affected as a result of the exercise of government power, the aggrieved party might have to ask the superior government agency for approval of writing-off the damages. The Civil Code permits the aggrieved party to seek for damages from the other party without making any plea to the relevant authority. By including the government authority in the categories of the third party, the Contract Law mandates the party in breach to first compensate the aggrieved party who suffers damages from the breach caused by a third party. After the compensation, the party in breach may seek redemption from the third party either under the agreement between them or according to the provision of law, particularly when the breach is caused by the action of the superior of the party in breach.

4. Bona Fide Third Party

The bona fide third party is regarded as another undeveloped area in the contract law in China although the concept itself has long been accepted in dealing with the civil matters that concern acquisition of movables. In China, it has been well established that if a piece of movable property is purchased by a third party who has no knowledge of imperfect title of the property in the transactions, the owner or the lien holder may not make the claim against the third party for the return of the property. According to the Supreme People's Court, the disposal of the community property (property owned in common) by one of the co-owners shall generally be held invalid during the existence of the ownership of community property, but if a third party acquired the property for value in good faith, the legitimate interests of the third party shall be protected.[13]

Although there has been no definition about the bona fide third party in China, it is generally understood that a bona fide third party is someone who is not the party of certain transactions but related in good faith to one of the parties in the transaction. The issue at core about the bona fide third party is how to reasonably protect the legitimate interests of such third party. In addition to the movable property, the other area where the bona fide third party is addressed most in China is agency.

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[13] See Supreme People's Court, *the Opinion (provisional) on Several Matters Concerning the General Principles of the Civil Law of China (1988)*, art 89.

There are several articles in the 1986 Civil Code that are aimed at protecting the third party in good faith with regard to the conduct of the agent. Article 65 of the Civil Code, for example, provides that if the power of attorney is unclear as to the authority conferred, the principal shall bear the responsibility towards the third party and the agent shall be held jointly and severally liable. But under Article 66 of the Civil Code, if an agent collaborates with a third party to harm the interests of the principal, the agent and the third party shall be held jointly and severally liable.

When drafting the Contract Law, there was a suggestion that the Contract Law should contain provisions concerning the bona fide third party. As a response to the suggestion, the initial draft of the Contract Law singled out the bona fide third party in a provision of contract assignment. The draft provision read: "a contract may not be assigned if the parties have the agreement prohibiting the assignment, but the agreement may not be used against a bona fide third party." This provision, however, did not gain an acceptance from the legislators, and as a result the phrase of the bona fide third party was removed from the final draft. There seemed to have at lease two concerns: one concern was that term of bona fide was not well defined and may cause confusions in its application. The other concern was the uncertainty about the standard under which the bona fide third party was to be determined.

The Contract Law is inevitably being under criticism for not having properly covered the issue of third parties. Not only does the Contract Law fail to offer protection to the bona fide third party, but also the Contract Law contains very limited provisions that involve the third party interests. Many suggest that in both assignment and consensual discharge of the contract by the parties, the interests of the third party must be sufficiently protected either by the future legislation or through judicial interpretation of the Supreme People's Court.[14]

[14] See Li Guoguang, *supra* note 4 at pp. 500–502.

Chapter XII
International Contracts

International contracts are commonly defined in China as the contracts that involve so-called "foreign elements". For this reason, the international contracts in China are quite often called foreign contracts. In general, a contract that has a "foreign element" is referred to either of the following: (1) a contract in which at least one of the parties to the contract is foreigner, stateless person, foreign enterprise or organization, (2) a contract that is concluded or performed in a foreign country or outside the territory of China, or (3) a contract that contains the subject matter located in a foreign country.[1] Although the term "foreign" normally denotes the place crossing the border of the nation, it in China may also include Hong Kong, Macao and Taiwan because of the unique status of these three regions.[2]

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[1] An British scholar defines the "foreign element" to mean "simply a contact with some system of law other than that of the 'forum'. . . . Such foreign elements in the facts of a case are quite common place: a contract was made with a foreign company or to be performed in a foreign country, or a tort was committed there, or property was situated there, or one of the parties is not English". See John H.C. Morris, *The Conflict of Laws* (5th ed), 2 (Sweet & Maxwell, 2000).

[2] For historical reason, China treats Hong Kong and Macao differently from the mainland. The structural format under which Hong Kong and Macao are being administrated after the handover is phrased as "one country with two systems." As part of its scheme to reunite the country, China has been trying to employ the same idea to deal with Taiwan, though there are tremendous resistances from Taiwan.

As indicated at the beginning of this book, the international contracts or foreign contracts were governed by a separate contract law named "Foreign Economic Contract Law" before the Contract Law was adopted in 1999. At that time, making foreign contracts was viewed as the business activities that required special rules. For example, in the Foreign Economic Contract Law, Chinese citizen was not eligible to be a party to a foreign contract.[3] The promulgation of the Contract Law unifies the laws that regulate all contracts regardless of foreign elements or nature. Thus, the international contracts and domestic contracts now are all under the same umbrella of the Contract Law

But the international contracts possess some distinctions that the domestic contracts do not have. A notable distinction is that in international contracts, both jurisdiction and choice of law are the issues that must be considered because of involvement of the foreign elements. To be accurate, for an international contract, the Chinese law may not apply to the disputes over the contract or the contract may be beyond the reach of the judicial power of the Chinese courts even though the contract is concluded or performed in China. In some contract cases, however, due to the concern about the state interests, the application of Chinese law is mandatory, which leaves no choice to the parties to select a foreign law as the governing law.

1. Choice of Law in International Contracts

The choice of law problem occurs wherever the parties have been subject to the authority of more than one sovereign state or nation. In the international business transactions, the most distinctive feature is that the transactions invoke the jurisdictions of multiple sovereigns, which makes the choice of law the matter mostly confronted by the lawyers engaged in international practice. Thus when drafting an international contract, the lawyer must think through the issues as to which law the contract will be subject, according to which rules the rights and obligations of the parties to the contract will be determined, and under which mechanism the disputes over the contact will be resolved. With a well-worded choice of law clause in the contract, the certainty and predictability about the transactions involved will be greatly enhanced.

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[3] The Foreign Economic Contract Law applied to "economic contracts, concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises, other foreign economic organizations or individuals". Clearly, the Chinese individuals were excluded from making a foreign contract. See Foreign Economic Contract Law (1985), art. 2. An English translation is available at http://www.qis.net/chinalaw/preclaw20.htm.

To draft a contract for the transactions that involve China may cause more concerns to foreign businessmen and their lawyers. The unfamiliarity with Chinese legal system aside, a very common view is that China is a country where the rule of law is lack. Although the last two decades have witnessed the fastest growth of Chinese economy in world, which indeed provided incredible business opportunities for foreign investors and companies, the concerns about the legal climates of the country seem to still remain high. The factors that cause the concerns may be many, but the lack of respect to the authority of law and the want of independent judiciary are perhaps the most striking ones.

Generally, in an international contract, the lawyer would carefully draft a choice of law clause to the extent that the contract could be possibly protected by the law of the client's own country, by the law that is similar to the client's national law, or at least by the law of a neutral country. In several other cases, however, the lawyer may choose to leave the choice of law issue open due to the difficulty encountered in reaching an agreement on the governing or applicable law for the purpose not to jeopardize the deal that the client really wants, with a hope that the choice of law matter may be negotiated and resolved at a later time. As an alternative, the lawyer would also try to make the contract under the governance of the existing trade usages / customs or internationally unified rules.

1.1. Choice of Law by the Parties

As far as the choice of law in international contracts is concerned, a well-established rule is to allow the parties to choose governing law. This rule is originated from the long-standing principle of freedom of contract, and is termed as "party autonomy". Classically, the freedom of contract was viewed as granting to the parties the power to regulate their own contracts. In other words, as Professor Kessler pointed out, as to the parties, the law of contracts is of their own making.[4] Under the party autonomy doctrine, if the parties have expressly chosen the law to apply to their contract, the law so chosen shall be the governing law of the contract.[5]

But when the choice is not made expressly, the issue is dealt with differently from country to country. In England, for example, if no choice of law is expressly made by the parties, the governing law may be inferred from the terms of the contract by the court through "applying sound ideas of business,

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[4] See Friedrich Kessler, *Contracts of Adhesion – Some Thoughts about Freedom of Contract*, 43 Colum. L. Rev. 629 (1943)

[5] See Jeffrey Ferriell & Michael Navin, *Understanding Contracts*, 7–8 (LexisNexis, 2004).

convenience, and sense to the language of the contract itself, with a view to discovering from it the true intention of the parties."[6] However, in many other countries, the parties' intent in terms of applicable law may not be inferred.

In common with the general practice elsewhere in the world, China now also recognizes the doctrine of party autonomy in the choice of law in foreign contracts, and the doctrine has been incorporated into the Contract Law to give the parties the right to choose the law that they see fit to govern the contract. Under Article 126 of the Contract Law, the parties to a foreign contract may choose the law applicable to the settlement of their contractual disputes except otherwise provided by the law. The choice may be made either in the form of a contract clause, namely the choice of law clause, or in a separate agreement, called choice of law agreement. The implication of Article 126 is that the law intended by the parties as a result of fair bargain between them will govern their contract.

However, there are several questions that are not clearly addressed in Article 126. The first question is whether the choice of law must be made expressly by the parties or may be inferred from the provisions of the contract by looking into the "presumed intent" of the parties. In practice, the Supreme People's Court of China takes restrictive stance by limiting the choice of law to the one expressly made by the parties. In its Answers to the Questions Concerning Application of Foreign Economic Contracts Law in 1987, the Supreme Court explicitly ruled out the implied choice of law by stating that the applicable law of contract by the parties must be the product of negotiation and must be made expressly.[7] Although the Foreign Economic Contracts Law was repealed after the adoption of the Contract Law, the Supreme People's Court's opinion is regarded to remain effective.[8]

The Supreme People's Court's position against implied choice of law is also endorsed by the Chinese Society of Private International Law (CSPIL). In 2000, the CSPIL published a Model Law of the Private International Law of the People's Republic of China (Model Law), aiming at providing a legislative reference to Chinese legislator for the future legislation. Article 100 of the Model Law, headlined as Party Autonomy, provides that a contract is to be governed by the law that is agreed upon and expressly chosen by the par-

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[6] See Morris, supra note 1 at p. 323.

[7] Supreme People's Court, *1987 Answers to the Questions Concerning Application of Foreign Economic Contracts Law*, art. 2, See *Gazette of the Supreme People's Court of the People's Republic of China*, Vol. 12 (1987) (hereinafter referred to as Answers).

[8] See Li Guoguang, *Explanation and Application of the Contract Law*, 528 (Xinhua Press, 1999).

ties except as otherwise provided by the law or by the treaties concluded by China or to which China is a member.[9] It then could conclude that in China the choice of law by the parties may not be implied by inference to the intent of the parties.

The second question is when the parties may make a choice of law that governs contract or the time for the parties to make the choice. Again, Article 126 of the Contract Law contains no indication of it, but the Supreme People's Court took a flexible approach allowing the parties to decide at anytime before the trial. According to the Supreme People's Court, the parties may choose the governing law at the time of contract, after the occurrence of disputes, or even before the court hearing starts. In addition, under the Supreme People's Court opinion, the contract disputes for which the parties may choose the governing law include those concerning conclusion of the contract, time for the conclusion, interpretation of the contract terms, performance of the contract, and modification, suspension, assignment, dissolution as well as termination of the contract.[10] But the capacity of the parties to the contract is not within the reach of the choice by the parties, nor is the formality of the contract.[11]

The third question concerns whether the law of country chosen by the parties must have a relation to the contract, the parties or the controversy. The relation requirement is used in some countries as a means to impose limitation on the choice of law by the parties. In the U.S for example, under the UCC, the parties to a contract involving international transaction may choose "the law of this State or of another State or country", "whether or not the transaction bears a relation to the State or country designated".[12] If, however, one of the parties to the transaction is a consumer, the choice of law by the parties will not be effective unless the transaction bears a reasonable relation to the State or country designated.[13] In China, at least from the Supreme People's

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[9] See the Chinese Society of Private International Law, *Model Law of the Private International Law of the People's Republic of China*, art. 100, published in 2000 by Law Publishing House (hereinafter referred to as Model Law); See also Han Depei, *Private International Law,* 198–199 (Beijing Higher Education Press and Beijing University Press, 2000).

[10] *See id.*

[11] As a general principle, the civil capacity, including the capacity to a contract, is determined by the "personal law", that is the law of the country of which the party is a citizen or a resident. Also, because the Contract Law has special requirements for the contract formality (writing, oral or other forms), the compliance with the formality requirements is critical to the validity of the contract that is concluded in China and such requirements may not be bypassed by the parties' choice of governing law.

[12] UCC Section 1-301 (c).

[13] UCC Section 1-301 (e).

Court viewpoint, such a relation is not required. Therefore, the parties may by agreement choose as governing law the Chinese Law, or the law of other country or region that is in force.[14] Under the Model Law, the parties may also choose international customs and international civil and commercial treaties.[15]

The forth question relates to whether the parties may choose different law to govern different parts of the contract. This is the issue concerning the splitting of the contract between different legal systems, which means that a contract may be governed by more than one law with reference to the different duties of performance or different matters of the contract. For example, the parties may agree that the validity of contract is to be governed by the law of country A, while the performance will be subject to the law of country B. In choice of law theory, this doctrine is called *dépeçage* or splitting. In China, there has been some voice advocating for the adoption of the *dépeçage* doctrine, and a notable representative of which is the Model Law. Under Article 100 of the Model Law, the parties may decide to apply the law they choose to the whole contract or only to one or several parts of the contract. But, the official recognition of this doctrine is not clear yet.[16]

The connotation of the law chosen by the parties also presents questionable issue. The issue is what the law so chosen actually means, or to be more specific, whether the chosen law is the whole law or specific law of a particular country. The issue is relevant because it may affect the meaningfulness of the choice of law by the parties. To illustrate, if the law chosen by the parties refers to the whole law of a country, it would include the conflict of law rules contained in the law of the country. In this situation, the law chosen by the parties may be displaced via a choice of law escape device so-called *renvoi* (also known as transmission or remission) with the law of the country that the parties have never designated. Realizing the potential problem of *renvoi* in the choice of law by parties, the people's courts in China are directed by the Supreme People's Court to regard the foreign law chosen by the parties as the substantive law of that country, excluding its conflict of law rules in order to avoid the *renvoi* problem.[17]

Indeed, the choice of law by the parties is premised on the notion of freedom of contract. But keep in mind that the contractual parties' freedom on

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[14] See Supreme People's Court, *Answers*, *supra* note 7, art. 4.

[15] See Model Law, *supra* note 9, art. 110.

[16] The problem that the *dépeçage* may cause is the case where "the two chosen laws cannot logically be reconciled in their application to a particular situation. See Morris, *supra* note 1 at p. 329.

[17] Under Supreme People's Court opinion, the foreign law the parties may choose is the substantive law of that country that is in effect. See Supreme People's Court, *Answers, supra* note 7, art. 4.

choice of law is limited and the exercise of the freedom to determine the applicable law is restrained in the situation where the freedom of choice confronts with the public policy, or a clash occurs between the freedom of choice and the mandatory rules. The public policy is the safeguard device by which the country in question, in order to protect the state or public interests, denies the application of a foreign law that is deemed to be in contradiction with the fundamental principles or policy of the nation. The mandatory rules are the rules that must be applied and should not be derogated through the contract. Like the public policy, the mandatory rules are also the common mechanism employed by a country to preserve its national interests. The distinct nature of the mandatory rules is the requirement for the application of the law of the forum country only.

In China, the choice of law by the parties is restricted in several aspects. First, the foreign law that the parties have chosen shall be excluded if its application would harm the social public interests of China. Pursuant to Article 150 of the Civil Code, the application of foreign laws or international customs shall not violate the public interests of China. Also under Article 142 of the Civil Code, in application of provisions of the international treaty, the provisions to which China has made reservation must be excluded. Second, the choice of law must be made by the parties with a mutual consent, and the choice of law clause that is concluded by fraud, duress, or any other means that violates the fairness principle will be null and void. And third, the choice of law shall not be made in violation of the rules that mandate the application of Chinese laws.

The exclusion of application of foreign law on the ground of public interests is known as public policy reservation and its purpose is to ensure that the application of foreign law will not offend the public policy of the forum state. According to the Supreme People's Court of China, when the applicable is a foreign law, but the application of which would violate the basic principles of the Chinese law and the social public interests, the application of foreign law shall be rejected and the Chinese law shall be applied instead.[18]

In certain cases, it is required that Chinese law be applied. At present, the mandatory application of Chinese laws mainly deals with the contracts involving foreign investment enterprises. It is clearly provided in Article 126 of the Contract Law that the laws of China shall apply to the contracts for Chinese-foreign equity joint ventures, for Chinese – foreign cooperative joint venture, or for Chinese – foreign cooperative exploration and development of natural resources to be performed within the territory of China. In short, the law governing these JV contracts may only be the Chinese laws. Also, under the Detailed Rules (as amended 2001) for Implementation of the Law of China on Wholly Foreign-Owned Enterprises (WFOE), for the contracts between a

[18] See *id*.

WFOE and other company, enterprise, other economic organization, or individual, the Contract Law of China shall be exclusively applied.[19]

The basic notion underlying the exclusive application of Chinese laws to the JV contracts is that foreign investment has great impacts on the national economy and the retaining of application of the domestic laws will effectively put the foreign investment under the reasonable control in light of the nation's interest. On the other hand, because of their business operation in China, the JVs all have the most substantial connection with China, which provides the reasonable ground for the exclusive application of Chinese laws. Moreover, a JV, once established in China, will become a Chinese legal person whom Chinese laws shall necessarily govern. It should be pointed out, however, that because of the Chinese legal person status of a JV, a contract between a JV and a foreigner (foreign company or individual) will be a foreign contract in which a foreign law may be chosen as the governing law.

The public policy reservation is also used to exclude application of foreign law when the parties try to evade the application of compulsory or prohibitive provisions of Chinese law. As noted, a contract that is foreign in China includes the one involving Hong Kong or Macao. Thus, for a contract concluded in the mainland and Hong Kong or *vice versa*, the choice of law would become an issue. Although within one country, due to the fact that the legal and social systems of the mainland differ from those of Hong Kong or Macao in many aspects, the application of the law of Hong Kong or Macao may be denied in the mainland because of public policy concerns. The case below would serve as a good example in this regard.

Bank of China (Hong Kong), Ltd.
v.
The Bureau of Foreign Trade and Economic Cooperation of Qinghai Province

The High People's Court of Qinghai (2003)
Qing Min San Zhong Zhi No. 3[20]

Plaintiff (Appellant), Bank of China (Hong Kong), Ltd. has its major business office in the Bank of China Tower at No. 1 Garden Road, Hong Kong. Defendant (Respondent), the Bureau of Foreign Trade and Economic Cooperation of Qinghai Province, is located at No. 25 Xishulin Lane, Xining City, Qinghai Province.

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[19] *See* Art. 181 of the Detailed Rules on Implementation of the Law of China on Wholly Foreign-owned Enterprises, amended on April 21, 2001. A similar provision is also contained in the newly amended Law of China-Foreign Equity Joint Ventures and its Implementation Rules.

[20] See the National Judicial College & People's University Law School, *An Overview of the Trial Cases of China (Volume of Commercial Cases 2004)*, 83 (People's Court Press and People's University Press, 2005).

In July 1988, plaintiff and Haihu Trade Inc. Ltd. (Haihu Trade), a company incorporated in Hong Kong as a show-window of the province, established a credit relation under which plaintiff granted Haihu Trade a credit line of HK$17.5 million. On July 6 of the same year, Defendant issued an irrevocable Letter of Guaranty for Haihu Trade to guarantee the repayment of the loan. Haihu Trade defaulted in repayment of the loan. On February 23, 1998, defendant wrote to plaintiff confirming that the Letter of Guaranty remains effective and the confirming letter also indicated that the guaranteed loan amount should not exceed HK$19.5 million. On March 6, 1998, in its "Letter of Commitment to Loan Repayment" sent to plaintiff, Haihu Trade admitted that the total amount of the loan owed to plaintiff was HK$19,021,625.04 and Haihu Trade promised to repay the loan in 18 installments.

Haihu Trade repaid a portion of the loan and then defaulted again. In November 2000, plaintiff filed lawsuit against defendant at Xi Ning City Intermediate People's Court, alleging that as of November 11, 200, defendant owed to plaintiff a total amount of HK$18,022,000. Plaintiff requested that (a) defendant, as the guarantor, pay plaintiff HK$18,022,000 as the principal and interests of the loan, and (b) defendant bear all litigation fees.

Defendant argued that it was a government agent, and was not allowed to guarantee any debts under the law. Therefore, according to defendant, the loan guarantee was invalid because defendant was lack of legal capacity as the guarantor. Defendant then moved for dismissal of plaintiff's claim. At the hearing, both plaintiff and defendant agreed that their disputes should be governed by the law of Hong Kong.

The trial court found that in March 2000, plaintiff brought an action against Haihu Trade at the Trial Division of Hong Kong High Court and asked the High Court to order Haihu Development Inc. Ltd. and other two individuals, Haihu Trade's guarantors in Hong Kong, to pay off the loan. In April 2000, Hong Kong High Court entered a judgment in favor of plaintiff, and the total amount of the unpaid loan was affirmed by High Court to be HK$16,247,546.78 (HK$14,460,586.96 plus interests). The trial court further found that due to their insolvency, Haihu Development Inc. Ltd. was liquidated on October 25, 2000 by the order of the Hong Kong High Court and other two individuals were declared bankrupt, leaving the loan unpaid.

The trial court was of opinion that the conduct of guaranty by defendant not only violated the provisions of law of the mainland, but also was in violation of the ordinances of Hong Kong. The trial court then held that because of its illegality, the guaranty in question should be invalid, and plaintiff's requesting defendant to be responsible for the unpaid loan should therefore be denied due to lack of legal grounds. Based on its holding, the trial court dismissed plaintiff's claim.

On appeal, plaintiff argued that the trial court erred with regard to the determination of the fact and application of law. Plaintiff asserted that the loan guaranty by government agency did not violate the law of Hong Kong, and the trial court decision that there was no legal ground to support plaintiff's claim and governmental guaranty violated the law of Hong Kong was a clear error. Plaintiff also asserted that although the legal systems between Hong Kong and the Mainland were different, they each had the civil compensation system applicable to the situation where the voidance of a contract was caused by the fault of a party. Plaintiff alleged that defendant misstated its legal capacity as the guarantor for the loan, which led plaintiff to establish the credit line for Haihu Trade in reliance on defendant's Letter of Guaranty, and thus no matter whether the defendant's act as guarantor was valid or not, defendant was 100% at fault for which defendant should be held liable.

Defendant rebutted by arguing that the contract of guaranty was invalid and the invalid contract should not give rise to the cause of action for plaintiff's lawsuit. Defendant further argued that under the Hong Kong statutes and cases, if a contract is prohibited by law, or

is illegal on its face, it should not be enforced. Defendant stressed that because the guaranty contract in question was null and void, and there was in addition no evidence to prove that plaintiff had a valid creditor rights against defendant, the appeal must be dismissed.

This Court finds that the facts and evidences ascertained by the trial court contained no error. Further, we are convinced that the total loan amount as specified in the judgment of Hong Kong High Court against Haihu Development Inc. Ltd. and other two individuals in Hong Kong should be HK$16,247,456.78, of which HK$14,460,586 was the principal. With regard to the evidence produced by plaintiff concerning Hong Kong ordinances, its contents mostly deal with city development and public utilities, and the provisions about the government guaranty has special meaning and particular application that are all irrelevant to this case. Also, defendant's assertion of Hong Kong statutes and cases should be denied as well because there is no sufficient evidence that such statute and cases are applicable to the case in question.

Pursuant to Article 194 of the Supreme People's Court 1988 Opinions on Several Questions concerning Implementation of the General Principles of Civil Law (provisional), the conduct of the parties to evade the compulsory or prohibitive provisions of law of China shall give no effect to the application of foreign law. Under the law of China, it is imperative that a Chinese institute providing guaranty overseas must first obtain an approval, and register with, the foreign exchange administration authority, and it is prohibited that government agent becomes a guarantor. In the instant case, since the guaranty contract was not approved by the foreign exchange administration authority and defendant acted as a guarantor in the name of government agent, defendant's conduct in fact evaded the compulsory and prohibitive provisions of law. On this ground, we hold that the application of Hong Kong law must be ruled out with regard to defendant's conduct of evasion despite the fact that the parties agreed that the contract should be governed and interpreted under the law of Hong Kong.

As far as defendant's 1998 reaffirmation of the validity of the Letter of Guaranty is concerned, it must be determined under the Law of Guaranty of China and relevant judicial interpretations. According to the Guaranty Law, this contract must be held invalid. However, as the facts of the case indicate, defendant, in its Letter of Guaranty, stated that it had all authority for the guaranty, but in fact, it did not comply with the required procedures for approval and registration. On the other hand, both parties knew or ought to know that a government agent was prohibited from being a guarantor, but ignored this provision and entered into the guaranty contract any way, which resulted in the avoidance of the contract. In this situation, both parties were found at fault. Therefore, we must hold that defendant should be liable for 50% of the unpaid loan of Haihu Trade.

Thus, in accordance with Article 153 (2) of the Civil Procedure Law of China and Article 7 of the Supreme People's Court Explanations to the Questions related to the Application of the Law of Guaranty of the People's Republic of China, it is so ordered:

1. The Ning Jing Chu Zi No. 81 Civil Judgment of Xi Ning City Intermediate People's Court be vacated;
2. Defendant the Bureau of Foreign Trade and Economic Cooperation of Qinghai Province be liable for the payment of 50% of the unpaid loan of HK$14,460,586.96 plus interest to plaintiff Bank of China (Hong Kong), Ltd., and the payment be made within one month after this judgment takes effect; and
3. The trial and appeal litigation fees in the amount of RMB 211,054 be borne by plaintiff and defendant each RMB 105527.

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The judgment of the Qinghai High People's Court in *Bank of China (Hong Kong), Ltd.* with regard to the liabilities of the parties was based mainly on Article 5 (2) of the Law of Guaranty of China. Under Article 5 (2), if a guaranty contract is determined to be null and void, the debtor, the guarantor or the creditor who is at fault, shall bear civil liability according to their respective fault. But the important part of this case for our purpose is the exclusion of the law chosen by the parties on the ground of violation of mandatory or prohibitive provisions of law of the forum, namely the mainland China. Another interesting part of the case is that the appellate court heavily relied on the Supreme People's Court opinions and interpretations in making its judgment, which usually was not the case.[21]

1.2. Application of Law Absent the Parties' Choice

If there is no choice of law by the parties, the governing law is then determined by a complex standard based on the degree of relationship or nexus between the contract and the particular country. In China, such standard is called the "closest relationship" standard. Under Article 126 of the Contract Law, which originates from Article 145 of the Civil Code, if the parties to a foreign contract make no choice of law, the law of the country to which the contract is most closely related shall apply. The "closest relationship" standard sometime is phrased as a Chinese version of the American approach of the "most significant relationship" advanced in the Restatement (Second) of Conflict of Laws (1971), or of the "closest connection" doctrine adopted by the Rome Convention on the Law Applicable to Contractual Obligations.[22]

The determination of governing law on the ground of "connection" or "relationship" is a complicated matter because it in most cases involves an analysis of all related factors in order to find the "closest" one, and the analysis is normally conducted by the court on a case by case basis. In China, the term "closest relationship" is not defined in the 1986 Civil Code and the Contract Law, but this standard, as being applied by the people's courts, focuses on the nature of contract and type of transactions, also collectively called "characteristics of performance".[23]

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[21] As discussed in the beginning of this book, because of the civil law tradition in China, the Supreme People's Court opinions may not be taken as the law.

[22] The Rome Convention was adopted by the EC in 1980 to deal with the matters of conflict of laws in contracts among its member countries.

[23] This practice is based on the so-called "characteristic performance" – a doctrine that is featured on the performance which is characteristic of the contract with a focus on the link between the contract and the social and environment of which it will form a part. For more discussion about this doctrine, see Morris, Conflict of Laws (5th Ed), 321 (Sweet & Maxwell, 2000).

In their practice, the people's courts normally follow the guidance set forth by the Supreme People's Court in 1987.[24] The guidance provides a laundry list for determining the law applicable to the different contracts in accordance with the "closest relationship" test.[25] For example, under the guidance, absent parties' choice of applicable law, the contract for international sale of goods shall be governed by the law of the place where the seller's business office is located at the time of conclusion of the contract. If the contract is concluded at the place of buyer's business office, or the contract is made mainly according to the terms and conditions stipulated by buyer or on the basis of buyer's bidding request, or the contract clearly provides that the seller shall deliver the goods at the place of buyer's business office, the law of the place of the buyer's business office at the time of contract shall apply.[26]

Notwithstanding the guidance, a people's court may within its discretion make determination of governing law based on the facts of the individual case. For example, if the court finds that a particular place to which the contract is most closely related, the law of such place may then be applied. Another example is the finding of business place of a party. If the law of a party's business place shall be applied and the party has more than one business offices, the people's courts shall apply the law of the place that is found most closely related to the contract. If there is no such business office, the law of the party's domicile or residence shall be applied.[27]

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[24] The guidance was provided in 1987 Supreme People's Court "*Answers to Several Questions on Application of Foreign Economic of China*". As noted, although the Answers were repealed after the Contract Law was adopted in 1999, the Opinions stated in the Answers are still the authoritative resources for the practice of people's courts. According to the Supreme People's Court, in regard to the following contracts, the laws determined by the people's courts under the closest connection standard shall be as follows: (a) contract for bank loan or guarantee – law of the place where the bank is located; (b) insurance contract – law of the place of insurer's business office; (c) contract for product processing and work – law of the place where the contractor's business office is situated; (d) contract of transfer of technology – law of the place of transferee's business office; (e) contract for construction project – law of the place of the project; (f) contract for technical consultation or design – law of the place where the commissioning party's business office is located; (g) contract for service – law of the place of service performance; (h) contract for supply of set equipment – law of the place where the equipment is installed and operated; (i) contract of agency – law of the place of agent business office; (j) contract for lease, sale or mortgage of real property – law of the place of property; (k) contract of the leasing of chattels – law of the place of lessor; (l) contract for storage and warehousing – law of the place where the storekeeper's business office is located. *See id.*

[25] *See id.*

[26] *See id.*

[27] *See id.*

Once again, the applicable law determined by a people's court should be the existing substantive law of the country (place) specified, not including the conflict of law rules of the foreign country. However, if within that foreign country different laws are applied in different states, the applicable law shall be the one pointed by the conflict of law rules prevailing in that foreign country. If there is no applicable conflict of law rules, the law of the state to which the contract is most closely related will be applied.[28]

1.3. Application of International Law

To apply international law in international contracts encounters two basic questions: the first question is whether the parties may choose as the governing law the international law, and the second question is whether a court may apply the international treaty in case of no choice made by the parties. In both situations, an underlying issue is whether the court may directly apply the international law to the controversy brought before it. Closely related to this issue is the question about which shall prevail if there is a conflict or discrepancy between the international law and domestic law.

International law, as specified in the Statute of the International Court of Justice, includes international treaties, international customs, the general principles of law recognized by civilized nations, and judicial decisions and scholarly treatises.[29] But the international treaties and customs are generally considered to be the two most authoritative sources of international law. When applying international treaties in the domestic courts, countries differ from each other in terms of how the international treaties should be applied in the domestic courts.

Generally, there are three different approaches in handling the application of international treaties. The first approach is direct application, which means that an international treaty may be directly applied in the courts of the country that is the party to the treaty except for the treaty provisions to which the country has made reservation. The second approach is termed as indirect application. Under this approach, an international treaty may not be applied

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[28] See Supreme People's Court, *Opinions on the Matters of Implementation and Application of the General Principles of Civil Law of China* (1988), art. 192.

[29] Article 38 of the Statute of the International Court of Justice provides: "the Court, whose function is to decide in accordance with international law such disputes as submitted to it, shall apply (a) international conventions, whether in general or particular, establishing rules expressly recognized by the contesting states, (b) international custom, as evidence of a general practice accepted by law, (c) the general principle of law recognized by civilized nations, (d) subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of law." Available at http://www.icj-cij.org

in the domestic courts without a process of transformation of the treaty into the domestic law. In other words, in order for a domestic court to apply an international treaty, there must be a statute passed by the legislature of the country to implement the treaty.[30] The third approach is called an eclectic approach because it basically a combination of the above two approaches. For example, in the United States, the treaties are divided into self-executing and non-self-executing. A treaty becomes enforceable in the courts of the United States only if it is self-executing. If a treaty is non-self-executing, it is enforceable only if it has been implemented through the federal statute.[31]

In China, it is up-to-now hard to tell which approach is being taken. As we have discussed above, the Model Law has advocated that the parties may choose as governing law the international treaty or customs, but neither the 1986 Civil Code nor the Contract Law has said so. With regard to the application of international treaty, the only relevant provision is Article 142 of the Civil Code. Under Article 142, if any international treaty concluded or acceded to by the People's Republic of China contains provisions differing from those in the civil laws of China, the provisions of the international treaty shall apply, except for those to which China has made reservations. Article 142

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[30] There are two theories that are intended to define the relationship between domestic law and international law, and they are called the dualism and monism. Under the dualism, domestic law and international law are two different systems regulating different subject matter, and neither legal order has the power to create or alter rules of the other. When domestic law provides for application of international law within the jurisdiction, this is merely an exercise of the authority of the authority of domestic law, an adoption or transformation of the rules of the international law. And therefore, application of international law in domestic courts is indirect. The monism however emphasizes the supremacy of the international law and reduces the domestic law to the status of pensioner of international law. Pursuant to monism, international law will be enforced directly in the domestic courts. See Weston, Falk & Charlesworth, *International Law and World Order, A Problem-Oriented Coursebook* (3rd Ed), 229–233 (West, 1997).

[31] Although there is a general acceptance in the US about the concepts of self-executing and non-self-executing treaties, the criteria used by the courts to distinguish self-executing treaties from non-self-executing treaties vary. One standard is to look at whether the treaty creates a private right of action. Under this standard, a treaty would be called non-self-executing if it does not create a private right of action. Another standard is the test used by the Ninth Circuit Court of Appeals in *Islamic Republic of Iran v. Boeing Co.*, 771 F. 2d 1279, 1283 (9th Cir. 1985). According to this test, to determine whether a treaty is self-executing or not, the following factors need to be considered: (a) the purposes of the treaty and the objectives of its creators, (b) the existence of domestic procedures and institutions appropriate for direct implementation, (c) the availability and feasibility of alternative enforcement methods, and (d) the immediate and long-range social consequences of self or non-self execution.

further provides that international customs may be applied absent applicable law or international treaties.

Obviously, Article 142 is ambiguous. First of all, it is uncertain as to whether the authority of treaty over domestic law as implicated in Article 142 would be interpreted to mean that international treaty would be applied directly in the courts. Secondly, it is unclear whether Article 142 actually authorizes the courts, without legislative actions, to apply the international treaties or customs to the cases where the application of the treaties or customs becomes necessary. And thirdly, it is questionable whether a later legislation may supersede the provisions of the treaty. Put differently, the question would be whether the treaty should still prevail if a later legislation appears to be inconsistent with the treaty.

Scholars in China have different views on this matter. Those advocating for direct application argue that the treaty is directly applicable in China once verified by the National People's Congress (NPC) because under Chinese Constitution, only the verification by the NPC is required for a treaty to become effective in China.[32] It is further argued that the NPC verification is just a formality that does not involve the substance of the treaty, and thus the legislative implication of a treaty in domestic law is not a condition for the application of the treaty.[33]

Others disagree to the direct application by pointing out that application of a treaty involves the exercise of national sovereignty and therefore shall not take place automatically in domestic courts without legislative authorization.[34] Some also suggest that the direct application be limited to the treaty of general civil and commercial matters, that is, if the treaty involves more policy matters, such as the WTO, the application should first be authorized by the legislation. What they are concerned about are the complexity of the policy-based treaty as well as lack of knowledge and competency of the judges in this regard.[35]

In practice, the Supreme People's Court seems to be in favor of the direct application of the international treaties and customs at least for civil and commercial matters.[36] On April 17, 2000, in order to guide the lower courts, the

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[32] See Li Shuangyuan, *Unification Process of Private International Law (2nd Ed)*, 365–366 (Wuhan Universty Press, 1998).

[33] See *Id*.

[34] See Liu Hanfu, *Matters Concerning Direct Application of the WTO in the People's Courts*, 7 People's Justice, 49 (2000).

[35] See Cao Jianming, *The WTO and China Judicial Practices*, 254–258 (Law Press, 2001).

[36] See Cao Jianming, *id.*

Supreme People's Court issued the *Notice on Several Questions that Deserve Attentions Concerning Trial and Handling of Foreign Civil and Commercial Cases*. In the Notice, the Supreme People's Court explicitly instructed the lower courts to honor the choice of law clause made by the parties except for otherwise provided by the law, and to give priority to the application of international treaties as well as deference to the international customs.[37]

As a matter of fact, there have been instances in China where the international treaties were directly applied in courts. The following case serves as an example showing how the international treaties are being cited as legal authority by Chinese people's courts in their trials of foreign cases. The case involves the application of the United Nations Convention on Contracts for the International Sale of Goods, and is selected by Shanghai High People's Court to publish as a typical case of particular importance.

Shanghai Dong Da Import and Export Co., Inc.
v.
Laubholz-Meyer Company

Shanghai Yangpu District People's Court
Yang Jing Chu Zi No. 1179 (2001)[38]

On March 15, 2001, plaintiff Shanghai Gong Da Import and Export Co., Inc. (a Chinese corporation, note added) was entrusted as an agent to enter into an import agent contract with Shanghai Chenchuan Industrial Company, Ltd. (Chenchuan) to import 15 cubic meters (+/–10%) of special timbers (known as Hornbeam) for Chenchuan. On the same day, plaintiff signed a contract with defendant (a German company, note added) under which defendant would provide required timbers according to the quantity, quality, price and payment methods as agreed upon by the parties.

On May 28, 2001, plaintiff received 13.999 cubic meters of the timbers from defendant under the B/L No. HD-MUBMCH10030, for which plaintiff paid to defendant via L/C US $5179.63, or RMB 42,991 Yuan, plus custom duties of RMB 10,434.24 Yuan. However, an initial inspection indicated that the timbers received did not conform to the terms of the contract. Plaintiff then asked the local Entry/Exit Bureau of Examination and Quarantine for further inspection. In the Inspection Certificate issued by the Bureau on June 14, 2001, it stated that among the imported timbers, about 192 pieces were not Hornbeam, amounting to 2.628 cubic meters, and about 52% of the timbers had poor quality. The Inspection Certificate concluded that the specification and the quality of the timbers did no meet the requirements of the contract.

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[37] See Supreme People's Court, the Notice on Several Questions that Deserve Attentions Concerning Trial and Handling of Foreign Civil and Commercial Cases (2000), a full text of the notice is available at http://www.law-lib.com

[38] See *"The 2003 Selected Cases Tried by People's Courts in Shanghai"*, 166–170 (Shanghai People's Court Press, 2004).

Plaintiff brought this action against defendant at the court. According to plaintiff, due to the defendant's breach of the contract, Chenchuan, plaintiff's principal, was unable to deliver the digital piano keyboard to a Japanese company, for which Chenchuan had to pay the liquidated damages of RMB 100,000 Yuan. Plaintiff claimed that because of the breach, plaintiff and its principal suffered both economic losses and reputation damages. Plaintiff then asked the court to order defendant to pay to plaintiff (a) the contract price of RMB 42,991 Yuan, (b) custom duties of RMB 10,434.24 Yuan, (c) Chenchuan's economic damages of RMB 100,000 Yuan and reputation damages of RMB 50,000 Yuan, and (d) RMB 2,653 Yuan as the fees paid by plaintiff to the Shanghai Representative Office of German Industry and Commerce Chamber (German Chamber Fees).

Defendant challenged the legality and relevance of the Inspection Certificate on the ground that the Certificate could not prove the inconformity of the goods to the quality standard set forth in the contract. Defendant argued that plaintiff failed to make inspection according to statutory process upon arrival of the goods, but rather plaintiff made the inspection when plaintiff thought there were quality problems after the timbers were unpacked for use. In addition, defendant argued, the inspected timbers had been sorted by plaintiff and were heavily damaged. For this reason, defendant asked the court to quash the Inspection Certificate because the inspected goods were not necessarily the goods under the B/L No. HD-MUBMCH10030.

Defendant further argued that the United Nations Convention on Contracts for the International Sale of Goods should first be applied to this case. Under the Convention, defendant asserted, its performance basically meet the terms of the contract, and even if defendant was found in breach, its liability for damages should be limited. Defendant then asked the court to dismiss plaintiff's claim for the reason that the damages claimed by plaintiff were lack of legal grounds.

The court finds that plaintiff did not make the timely inspection of the timbers and had the timbers inspected after the timbers arrived at the working site without presence of defendant's local representatives. In this regard, plaintiff was at fault to certain extent. But court believes that the evidential effect of the Inspection Certificate shall not be denied only because of plaintiff's fault. First, based on the evidence provided by plaintiff, the timbers purchased by plaintiff are to be used to produce specially made products, and therefore the required timbers may not be substituted with other type of timbers. The contract between the parties is clear about the specification of the timbers, defendant, however, changed the specification without plaintiff's knowledge. And it was after being unpackaged that the timbers were found wrong. Therefore there is no evidence that plaintiff committed any fraudulent conduct in inspecting the timbers.

Second, the evidences before the court concerning Chenchuan's payment to the Japanese company for the liquidated damages further indicates that both plaintiff and Chenchuan did not have any Hornbeam timbers from other sources in stock. Thus, it is reasonable and logical to infer that there is no basis for plaintiff to switch the timbers for the purposes of inspection. On this basis, it should be held that the timbers provided for inspection were imported from defendant and therefore the evidential effect of the Inspection Certificate should be affirmed.

With regard to the application of law, according to Article 2 of the Supreme People's Court's "the Notice on Several Questions that Deserve Attentions Concerning Trial and Handling of Foreign Civil and Commercial Cases" on April 17, 2000, except for the provisions of Article 126 (b) of the Contract Law under which Chinese law must be applied, the applicable law to a contract should be determined exactly under the provision of law or the choice of the parties. The priority shall be given to international treaties, excluding

the provisions to which China has made reservations, and the application of international customs may also be considered. In this case, the parties did not make the choice of law in the contract. But since the counties of which the parties are citizens are both the members of the United Nations Convention on Contracts for the International Sale of Goods, the contract falls within the scope of the application of the Convention, and then the Convention shall first be applied.

Under the provisions of the Convention, defendant shall be held liable because defendant fails to deliver the goods that match the specification and quality provided in the contract and such failure constitutes a "fundamental" breach. But with regard to the liquidated damages Chenchuan paid to the Japanese company and the reputation damages claimed by plaintiff, plaintiff provided no evidence that defendant was in advance informed of Chenchuan and the transactions with the Japanese company, plaintiff's claims in this regard therefore shall be denied.

The court hereby holds that after the contract is legally concluded, the parties shall fully perform the contract. But due to defendant's breach, plaintiff did not achieve what it has bargained for, and defendant shall of course be liable for damages. Plaintiff's claims for the returning the goods delivered for a refund, the payment for the import duties, and other fees in relation to the returning of goods should be supported because they are the consequences of breach that could be foreseen by defendant.

On the grounds stated above, in accordance with Article 142 of the General Principles of Civil Law of China, Article 25, Article 49 (1)(a), (2)(b), Article 51 (2), Article 81 (2), and Article 86 (1) of the United Nations Convention on Contracts for the International Sale of Goods, it is now ordered as follows:

1. Defendant Laubholz-Meyer Company refund plaintiff Shanghai Dong Da Import Co., Inc. RMB 42,991 Yuan within 10 days after this judgment takes effect;
2. Defendant Laubholz-Meyer Company pay plaintiff Shanghai Dong Da Import Co., Inc. RMB 10,434.24 Yuan of the import related costs within 10 days after this judgment takes effect;
3. Defendant Laubholz-Meyer Company pay plaintiff Shanghai Dong Da Import Co., Inc. RMB 2,653 Yuan of German Chamber fees within 10 days after this judgment takes effect;
4. Plaintiff's other claims be denied;
5. Defendant, within 10 days after Plaintiff Shanghai Dong Da Import Co., Inc. receive the above ordered payments from defendant, shall come to the place designated by plaintiff to pick up the Hornbeam timbers 11.371 cubic meters, and other timbers 2.628 cubic meters at its own cost; if plaintiff is unable to provide the timbers to the amount as specified above, plaintiff shall pay to defendant the difference at US$370 / cubic meter.

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None of the parties made appeal in *Shanghai Dong Da*. At the time of publication of the case, the head judge who wrote the opinion made several interesting comments. First, this case involves the dispute over the specification and quality of the contracted goods. During the trial the court had a clear focus on evidence by determining first the validity and effect of the Inspection Certificate, and then the matter of "fundamental breach" by defendant.

Second, under Article 1(a) of the United Nations Convention on Contracts for the International Sale of Goods, the Convention applies contracts of sale of goods between parties whose places of business are in different States (a) when the States are Contracting States. In this case, the counties of both parties are the signatory counties of the Convention, and there was no choice of law made by the parties in their contract. Therefore, in accordance with the Supreme People's Court's Notice on April 17, 2000, the court shall apply the provisions of the Convention to the case.

Third, under the provisions of the Convention, in case of a fundamental breach of contract, the damages for which the party in breach is liable shall be those suffered by the aggrieved party as a result of the breach including profits. But the damages shall not exceed the possible amount the party in breach could or ought to foresee based on his knowledge and the situation at the time of contract. It was on this ground that the court granted some of the plaintiff's claims, and denied some.[39]

This case was selected by the Shanghai High People's Court to publish in part because its exemplary effect of application of international treaty. The case becomes a prototype for a number of reasons. First, this is the case where the people's court directly applied the international treaty to the foreign contractual dispute. Second, in this case the people's court made the parties subject to the provisions of the treaty without referring to any domestic legislation. Third, the application of the treaty was initiated by the people's court absent parties' choice of law.

2. Choice of Forum in International Contracts

Choice of forum occurs when the parties in their contract choose in advance a court before which the disputes arising out of or related to the contract will be brought. Doctrinally, the jurisdiction that a court obtains from the choice of forum clause is defined as consensual jurisdiction, and the jurisdiction by consent is recognized as a jurisdictional basis in many countries. In U.S., the choice of forum by the parties was generally not enforced until 1972 when the U.S. Supreme Court in the *Bremen* case rejected the traditional view that

[39] See *id*., at p. 170.

the forum choice clause tends to "oust a court of jurisdiction".[40] By vacating the lower courts' judgment, the Court held that the forum clause would be enforced unless there was a clear showing that "the enforcement would be unreasonable and unjust".[41] The Conflict of Laws Restatement (Second) also permits that the parties' agreement as to the place of the action will be given effect unless it is unfair or unreasonable.[42]

The rationale for allowing the parties to a contract to choose a court to adjudicate the disputes rests with the goal to achieve certainty of dispute settlement and convenience to the parties. The assumption is that the choice of forum clause implicates an attempt of the parties to ensure that the action will be brought in a forum that is convenient to them, and a commitment of the parties to binding themselves as to the place of litigation, whereby the certainty for the dispute settlement will be established. An argument, however, is that the choice of forum clause is not to give the parties the power to alter the rule of jurisdiction, but rather it only provides a ground on which a court may restrain from exercising the jurisdiction.[43] Nevertheless, whatever arguments there might be, the choice of forum is in fact an extension of the freedom of contract to the court jurisdiction.[44]

Like in many other countries, the choice of forum is allowed in China, but on a limited basis. The jurisdiction of Chinese people's courts in civil cases is prescribed in both the Chinese Constitution (1982, as amended 2004) and the Civil Procedural Law of China (CPL). With respect to foreign civil litigation, the jurisdiction of the people's courts is governed by both the general and special provisions of the CPL. In addition, the Supreme People's Court also plays important role in determining the lower courts' jurisdiction pertaining to particular type of case. As far as the choice of forum is concerned, Articles 244

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[40] *Bremen v. Zapata Off-Shore Co*., 407 U.S. 1, 92 S. Ct. 1907.

[41] See *id.*

[42] See Restatement (Second) of Conflict of Laws, Section 80 (1971, as amended 1988).

[43] See Restatement (Second), comment (a).

[44] Choice of forum by parties is being recognized by many countries and a great deal of international efforts have been made as well. The most recent development in this regard is the 20th Session of the Hague Conference on Private International Law that was held at the Hague in June 2005, at which about 44 countries, including US and China, signed the Convention on Choice of Court Agreements. Under the Convention, subject to certain exceptions, a choice of court agreement which designates the courts of one Contracting State or one or more specific courts in one Contracting State shall be deemed exclusive unless the parties have expressly provided otherwise. Such exclusive choice of forum agreements is limited to civil or commercial matters.

and 245 of the CPL are the primary legal sources. Of course, the Supreme People's Court's explanations and opinions also play a vital role.

According to Article 244 of the CPL, the parties in the disputes concerning foreign contracts or foreign property rights may choose by a written agreement the jurisdiction of the court that has actual connection with the disputes.[45] A clear indication of Article 244 of the CPL is that the choice of forum is permissible, but subject to three conditions: (1) the agreement of choice of court must be made in writing, (2) the court so chosen must have "actual connections" with the disputes; and (3) the disputes must involve foreign contracts or foreign property rights. What seems to have a real relevance to our discussion on international contracts here is the requirement of "actual connections".

Neither the CPL nor the Supreme People's Court has clarified what the "actual connections" are. But it is generally held that the "connection" refers to certain point" or "locale". Many believe that pursuant to Article 25 of the CPL, the "point" or "locale" having actual connection with contractual disputes includes "place of a party's domicile or residence", "place of contract", "place of performance", "place of the object of the contract", or "place of a party's principal business office or business operation".[46]

By agreement, the parties to a contract may also choose a Chinese people's court to adjudicate their disputes arising out of or related to the contract. However, Article 244 requires that if a Chinese people's court is chosen, the parties' choice shall not violate the provisions of the CPL concerning tier and exclusive jurisdiction.[47] The "tier jurisdiction" refers to the jurisdiction of the people's courts at different levels and it tells at which level of the people's court a particular case shall be filed with in the first instance of trial. There are four tiers in the system of Chinese people's courts: the Supreme People's Court, the provincial high people's court, intermediate people's court (prefecture city level), and district people's court (county level).[48] Note that the judicial

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[45] See Civil Procedural Law of the People's Republic of China (herein after referred as the CPL), art. 224. An English translation is available at http://www.gip.net/chinalaw/lawtranl.htm.

[46] Under Article 25, the parties to a contract may through an agreement in writing choose the jurisdiction of the court of the place of defendant domicile, contract performance, contract conclusion, plaintiff domicile, or the object of the contract. See *id*. art. 25. It is true that Article 25 governs domestic litigation, but this provision is said to apply analogically to the determination of the actual connections in foreign contract cases.

[47] *See id*.

[48] At present, the total number of people's courts in China is 3,568, including the Supreme People's Court, 32 provincial high people's courts, 403 intermediate people's courts and 3132 district people's courts. Among these courts, 10 are maritime courts, 60 railway courts, and 88 military courts.

proceedings in China are conducted under a system called "two instance trials" under which in any given case there are one trial and one appeal only.[49]

The exclusive jurisdiction of Chinese people's courts consists of two parts. The first part concerns the specific locales that the disputes will involve, and the actions thereof shall be under the exclusive jurisdiction of particular Chinese people's court. In accordance with Article 34 of the CPL, (a) if a lawsuit brought on the dispute over real estate, the people's court of the place where the real estate is located shall have the jurisdiction; (b) if a lawsuit involving the dispute over harbor operations, the jurisdiction shall rest with the people's court of the place where the harbor is situated; and (c) if a lawsuit arising out of the dispute over succession, it shall be within the jurisdiction of the people's court of the place where the decedent was domiciled upon his death, or where the major estate is located.[50] In those cases, the jurisdiction of the court so designated shall not be altered by the choice of forum clause by the parties to a contract.

The second part of the exclusive jurisdiction of Chinese people's courts is the exclusion of the jurisdiction of any foreign courts. The CPL expressly denies foreign courts' exercise of judicial power over the civil actions involving the disputes on the contracts of foreign investment enterprises (FIEs). Article 246 of the CPL provides that the people's courts of China shall have the jurisdiction over the civil actions brought on disputes concerning the performance within China for contracts of Chinese – foreign equity joint ventures, Chinese – foreign contractual joint ventures, or Chinese – foreign cooperative exploration and development of the natural resources.[51] Theoretically, Article 246 itself does not have the effect of extraterritorially prohibiting a foreign court from taking the case that concerns an FIE contract either initiated by foreign plaintiff against Chinese defendant or referred by the consent of the parties. But the practical problem is that the judgment so obtained will not be enforced in China because under Chinese law, a foreign court lacks the subject matter jurisdiction over the cases as such.

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[49] In most cases, the first trial begins with the county level, and the appeal will be made to the intermediate people's court. However, there are certain cases where the intermediate people's court or provincial high people's court will take the first trial. Thus, if a case starts at a court of intermediate level, the appeal will be heard by a provincial high people's court, and if a higher court takes the case for the trail of first instance, the Supreme People's Court will have to take the case if an appeal follows. For general information about Chinese courts jurisdiction, see Mo Zhang, *International Civil Litigation in China: A Practical Analysis of the Chinese Judicial System*, 25 Boston College Int'l & Comp. L. R., 59 (Winter 2002).

[50] *See id*. art. 34.

[51] *See id.* art. 246.

An important nature of the forum choice clause is the consent of the parties. Such consent could be expressed by the parties, and may also be inferred from the contents of the contract, e.g. the choice of law clause, or from the conduct of the party or parties. In China, an inference of the choice of forum may not be made from the terms of the contract, but may be presumed from the conduct of defendant. In accordance with Article 255 of the CPL, in a civil action, if the foreign defendant raises no objection to the jurisdiction of a people's court and answers to the complaint or otherwise appears in response there to, the defendant shall be deemed to have accepted the people's court's jurisdictional competence.[52] The idea is that a party's attending the litigation in a court constitutes a surrender or waiver of the defense to the personal jurisdiction of the court, from which the consent of the party will be implied.

For a foreign lawyer, it is important to bear in mind that in Chinese judicial proceeding there is no such process as "special and limited appearance" as in many foreign courts for the purpose of challenging personal jurisdiction of the court or quashing service. If the jurisdiction becomes an issue in a Chinese people's court, it should be raised along with the submission of the answer to the complaint. In accordance with Article 38 of the CPL, after the people's court accepts the case, if a party disagrees to the jurisdiction of the court, it shall raise its objection during the time the answer is submitted, and then the court will make a decision on the objection.[53]

3. Dispute Settlement Mechanism

The disputes related to an international contract could be dealt with in different ways. The most ideal way, of course, is for the parties to negotiate a deal and to reconcile the differences between them. The advantages of the negotiation for a dispute resolution are obvious. At most, it will help settle the dispute amicably

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[52] *See id*. art. 243.

[53] It is important that a defendant raises a jurisdictional objection timely. Under Article 38 of the CPL, if a party to a civil action objects to the jurisdiction of a people's court, the objection must be raised within the time period prescribed for the filing of answers. According to Article 248, defendant who is not domiciled with the territory of China shall have 30 days to file his answers upon receipt of plaintiff's complaint. Thus, if defendant wants to challenge a people's court jurisdiction, he must do so within this statutory 30-day period. According the Supreme People's Court, a third party to the litigation may also challenge the jurisdiction of a people's court if the third party has an independent claim. Once the jurisdiction is challenged, the court shall have 15 days to review the challenge and make a decision in the form of court order. The court order on jurisdictional matter is appealable.

and consequently the business relations between the parties will remain unaffected. At least, the negotiation will provide a platform for the parties to communicate directly with each other and help find out what problems are. As a practical matter, negotiation is also a cost-efficiency means to resolve disputes in business transactions. But in most cases, the successful negotiation requires satisfactory compromise from both of the parties.

Unfortunately, however, because of different business interest concerns or conflicting motivation, the contractual parties some times are unwilling or hard to yield to each other or they could not reach a consensus on compromise. In this situation, the parties would have to employ other means to resolve the disputes. Alternatively, the parties may engage a third party to help mediate the disputes or submit their disputes to an agreed body for arbitration. The parities may also choose to litigate the disputes in a court. Thus, as far as the contractual dispute settlement is concerned, four options are generally available to the parties, they are, negotiation, mediation, arbitration or litigation. But the use of these options in terms of forms and conditions may differ from country to country.[54]

The four-option dispute settlement mechanism is a common practice in China as well, and the mechanism is also incorporated into the provision of the Contract Law to cope with contractual disputes. Under Article 128 of the Contract Law, the parties may settle their disputes concerning the contract through conciliation or mediation. If the parties are unwilling to settle the dispute by reconciliation or mediation, or the conciliation or mediation fails, they may apply to an arbitration institution, Chinese arbitration institution or a foreign one, for arbitration according to their arbitration agreement. If there is no arbitration agreement between the parties or the arbitration agreement is null and void, a lawsuit may be brought to a people's court.[55]

3.1. Reconciliation

For the purposes of the Contract Law, reconciliation primarily refers negotiation, which is, of course, the most desirable means to amicably settle any disputes the may arise out of the contract between the parties. In general, the reconciliation is conducted between the parties or through their legal representatives (e.g. lawyers) without participation of any third party. Through negotiation, the parties in disputes reach a settlement agreement on the basis of mutual understanding and benefits. Note that negotiation, though highly

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[54] In the U.S., the dispute settlements by the means other than litigation are collectively called "alternative dispute resolutions" or ADR.

[55] See the Contract Law, art. 128.

desirable, is not mandatory. In other words, the parties may directly choose other means other than negotiation to solve their disputes.[56]

Also as being the case sometimes, the reconciliation may involve the aid of a third party on whom the parties both have trust and confidence. In this situation, however, the role of the third party is limited, and in most cases the third party only serves as the negotiation facilitator. During the course of reconciliation, the third party normally will not put forward any proposal for the settlement of disputes between the parties, but will make efforts to bring the parties in disputes to the negotiation table.

3.2. Mediation

Mediation is used where the parties could not reach a settlement themselves but are willing to have their disputes heard by a third party. In contrast to reconciliation, there is a third party in mediation who has a role of making proposal for the parties in disputes. Keep in mind that mediation is widely employed in China as an effective way to "melt" the differences between the disputing parties without hurting either one. At present, there are four kinds of mediations that are being used in China, namely civil (non-judicial) mediation, administrative mediation, arbitral mediation (or mediation in arbitration) and judicial mediation.

Civil mediation is the mediation conducted by local community, usually by neighborhood committee or township committee. The purpose of the civil mediation is to help settle the dispute at a grass-root level. But because of its civil nature, the settlement agreement reached as a result of the civil mediation does not have the binding effect on the parties. If a party repudiates the settlement agreement of the civil mediation, the other party may not ask the court to enforce the agreement. Nevertheless, the civil mediation is greatly favored by the government because its obvious advantage is to help minimize the potential instability by diminishing the disputes at very basic level. But it may not be desirable to foreign lawyers in an international contract due to the concerns about local bias and non-binding characteristics of the settlement.

The administrative mediation, in the context of helping resolve the contractual disputes, is the mediation conducted by the administrative authority, mostly the authority of commerce and industry management. Under the *Methods of Administrative Mediation of the Disputes Concerning Contracts*, which was issued by the State Administration of Commerce and Industry on November 3, 1997,[57] the administration mediation will be instituted upon the

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[56] See Li Guoguang, *supra* note 8 at pp. 568–569.

[57] See the State Administration of Commerce and Industry, *Methods of Administrative Mediation of the Disputes Concerning Contracts*, articles 3 and 5.

request of the contractual parties in disputes on a voluntary basis, and will be conducted non-publicly unless otherwise asked by the parties. A successful mediation will produce a settlement agreement between the parties.

But once again, like the civil mediation, the administrative arbitration has no binding effect as to the enforcement of the settlement as agreed by the parties in the mediation. Thus the aggrieved party may have to resort to arbitration under the arbitration clause or to file a lawsuit if the other party repudiates the settlement agreement.[58]

Arbitral mediation involves mediation conducted by the arbitration body during the process of arbitration. Although mediation is not required in the arbitration, it is strongly preferable that the mediation be conducted before the arbitral award is made. According the Arbitration Law of China, the arbitration tribunal may conduct mediation prior to making an arbitral award. If the parties are willing to seek mediation, the arbitral tribunal shall conduct the mediation.[59] The striking difference between the arbitral mediation and civil or administrative mediation is that a settlement agreement reached as a result of successful arbitral mediation shall have the same legal effect as an arbitral award.[60] If a party fails to perform the settlement agreement reached through arbitral mediation, the aggrieved party may ask the people's court to enforce.

Judicial mediation concerns the mediation made by the court. Since the government policy in China is strongly in favor of mediation, the court is required by the law to conduct the mediation at any stage if possible before the judgment is rendered. Under the Article 85 of the CPL, during the trial of civil cases, the people's court shall distinguish between right and wrong on the basis of clear facts and mediate the disputes between the parties on a voluntary basis.[61]

It is further provided that if mediation is possible prior to rendering judgment, the court may still conduct mediation. But if mediation efforts prove to be unsuccessful, a judgment shall then be made without delay.[62] If through mediation the parties reach an agreement to settle the disputes, the court shall issue a document of settlement. The document shall be deemed as the court judgment, and will bind the parties unless a party changes mind before the document of settlement is handed down.[63]

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[58] See *id*., art. 20.

[59] See the Arbitration Law of the People's Republic of China, art. 51. An English translation is available at http://www.gip.net/chinalaw/lawtranl.htm.

[60] See *id*.

[61] See the CPL, art. 85, *supra* note 26.

[62] See *id*., art. 129.

[63] See *id*., art. 89, 91.

On September 16, 2004, the Supreme People's Court, in order to enhance judicial mediation, issued "the Rules for the Matters of Mediation of Civil Affairs in the People's Courts" (Rules).[64] Under Article 1 of the Rules, the people's courts may conduct mediation after the time for filing an answer and before the judgment is made for the civil cases of either trial, appeal or retrial.[65] But, upon the agreement of the parties, the mediation may be made before the time for answer expires. Article 2 of the Rules requires that the people's courts conduct mediation in all cases for which the settlement by mediation is possible.[66] The Rules restate the enforceability of the mediation agreement reached as a result of judicial mediation. However, under any of the following circumstances, the mediation agreement shall not be accepted by the people's courts: (a) harmfulness to the national and social public interests, (b) infringement of the third party interest, (c) violation of the true intention of a party, or (d) violation of compulsory provisions of law and administrative regulations.[67]

3.3. Arbitration

If, however, all efforts for mediation are futile, the disputes may have to be submitted to either an arbitration tribunal or a court for decision. As in many other countries, arbitration is also a popular device in China to resolve disputes in international contracts. As a matter of fact, a quite large number of international contracts in China contain a special clause calling for arbitration in case where the parties could not settle their disputes through negotiation and/or mediation. The major concern the lawyers have on both sides (Chinese company and its foreign counterparts), however, is the location of arbitration.[68] Within China, the foreign arbitration is conducted by China International Economic and Trade Arbitration Commission (known as CIETAC). The

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[64] The Rules was adopted by the Supreme People's Court on August 18, 2004, and effective November 1, 2004. The full text of the Rules is available at http://www.law-lib.com.

[65] Retrial is the trial conducted through the process of judicial supervision after the exhaustion of the trial and appeal.

[66] According to the Supreme People's Court, the civil cases that may not be mediated include the cases to which a special procedure, procedure of urging the clearance of debts, procedure of public summons for exhortation, or procedure for bankruptcy liquidation is applied, or the cases that involved determination of personal status such as marriage or paternity relation, or other cases unsuitable for mediation due to their nature. See Supreme People's Court, *Rules*, art. 2, *supra* note, 64.

[67] See *id*., Art. 12.

[68] Foreign lawyers prefer and in most cases try very hard to choose their home country arbitration institution or a third country arbitration body in their contracts with Chinese companies.

CIETAC is headquartered in Beijing and has two branches that are located in Shanghai and Shenzhen respectively.[69]

Of importance concerning arbitration here is the nature and effect of an arbitration agreement. First of all, in China an arbitration agreement may be made in the form of a contract clause or a separate agreement, and the agreement may be reached at the time of contract or at the time for arbitration. Secondly, the arbitration agreement serves as the legal basis on which the arbitration is to be conducted because the power of an arbitration body to arbitrate the disputes must be authorized by the parties in the form of arbitration agreement. If a party applies to the CIETAC for arbitration in the absence of arbitration agreement, the application will be denied. Thirdly, a valid arbitration agreement precludes the jurisdiction of a Chinese court over the disputes in question. But if a party wishes to pursuit the litigation in a courtroom in lieu of arbitration as provided in the contract, a strategy is to challenge the validity of the arbitration agreement. A court will take the case despite the arbitration agreement if the agreement is found invalid.

A related issue is arbitral award. In China, under the Arbitration Law, there is no appeal for an arbitration award. After an arbitral award is made, if a party institutes an action in a people's court for the same dispute, the action will be dismissed.[70] If however, the arbitral award or its enforcement is set aside by a people's court, a party may initiate an action in a people's court, or the parties, through a new agreement, may have the disputes arbitrated again.[71] Note that under the Arbitration Law, there are two types of cases that may not be arbitrated. The firs type includes disputes pertaining to marriage, adoption, guardianship, and succession. The second type consists of the disputes of administrative nature that should be handled by administration agencies as provided by law.[72]

Of course, the parties in an international contract that has Chinese element may by agreement seek for arbitration in a foreign arbitration body. As a practical matter, however, there may have an enforcement issue if the foreign arbitral award will need to be enforced in China. Under Article 269 of the CPL, if a foreign arbitral award needs to be recognized and enforced in China, the

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[69] Under the Arbitration Law of China, the CIETAC is organized by China Chamber of International Commerce (CCOIC), and CCOIC is associated with the China Council for the Promotion of International Trade (CCPIT). CCPIT, though claimed as a non-government institute/organization, is a semi-government agency, and the top officials of CCPIT are all the government appointees.

[70] See Arbitration Law of China, art. 9, *supra* note 59.

[71] See *id*.

[72] See *id*., art. 3.

party concerned shall directly apply to the intermediate people's court of the place where the party subject to the enforcement resides or his property is located. The people's court will handle the application according to the treaties concluded or acceded to by China or under the principle of reciprocity.

With regard to the arbitral award made by the CIETAC, in which a foreign party is involved, the party who seeks to enforce the arbitral award shall also make a request to a people's court, and then the court will review and exam the arbitral award. If any of the following presents, the enforcement of the arbitral award will be denied: (a) lack of arbitral agreement or clause, (b) lack of proper notice or opportunity to be heard to the person against whom the arbitral award is made; (c) violation of arbitration rules with regard to the composition of arbitration tribunal or the procedures of arbitration; (d) matters for arbitration not within the jurisdiction of the arbitration body or outside the arbitration agreement; or (e) violation of social and public interests.[73]

Quiet often, however, the intermediate people's courts, due to the concerns about local interest or pressures from local government, may abuse their discretionary power in reviewing the validity of the foreign arbitral award, and refuse to enforce a foreign arbitral award without justifiable reason. In order to make sure that the court's power to deny enforcement of a foreign arbitral award will not be abused, the Supreme People's Court in 1995 issued a notice establishing a two-layer reporting and reviewing system. Under the Supreme People's Court notice, before making a decision of denial, the intermediate court must report the case to the high people's court that has jurisdiction over the intermediate people's court for review. If the high people's court is to grant the denial, a similar report must be made to the Supreme People's Court for opinion before the denial is granted.[74]

According to the Supreme Court's notice, the two-layer reporting and reviewing system also applies to the determination of the validity of arbitration agreement requested by a party who attempts to have the arbitration agreement set aside and institute a lawsuit instead. In 1998, in another notice, the Supreme People's Court extended the two-layer reporting and reviewing system to the request for vacating the arbitral award made by the CIETAC in response to the increasing incidents where Chinese party tried to negate the effect of an arbitral award made by the CIETAC against it.[75]

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[73] See the CPL, art. 260, *supra* note 26.

[74] See Supreme People's Court, *the Notice Concerning Handling by the People's Court of the Matters Involving Foreign Arbitration*, August 28, 1995, Fafa (1995) No. 18.

[75] See Supreme People's Court, *the Notice Concerning the Matters To Vacate by the People's Court the Foreign Arbitral Awards*, April 23, 1998, Fa (1998) No. 40.

3.4. Litigation

Litigation is, perhaps, the last resort to the dispute settlement. Many foreign companies and their lawyers don't feel comfortable to have a lawsuit is a Chinese people's court. One major reason is that they are reluctant to do the litigation in a legal system with which they do not feel familiar. Another reason is that Chinese courts are deemed to have the reputation of lack of judicial independence. Whatever reasons there may be, the reality however is that in many cases foreign parties may have to end up with the litigation in a Chinese court. Although in contract cases, the parties are allow to choose forum, the choice, as noted, is subject to two restrictions: connection between the forum and the contract or dispute, and non-violation of the exclusive jurisdiction of Chinese courts.

Therefore, when drafting an international contract that involves a Chinese party, the foreign lawyer(s) may have think more about the options to deal with possible disputes. In addition to a carefully worded or phrased dispute settlement clause in the contract, a careful consideration on the possible outcome as well as the ultimate goal to achieve would need to be taken in order to reach a acceptable compromise. In certain situations, to have an arbitration or litigation in China does not necessarily mean a bad choice to the extent that the foreign party's interest would be effectively and adequately protected. An old Chinese saying may help explain the point here: if you don't go into the tiger's lair, how can you catch the cubs?

4. Statute of Limitations

The Contract Law contains a special statue of limitation. But this special statute of limitation only applies to two kinds of contracts: the contracts for international sale of goods and contracts for import and export of technology. Under Article 129 of the Contract Law, the time limit is 4 years for an action before the people's court or arbitration before the arbitration body concerning the disputes over contracts for international sale of goods or contracts for technology import and export. The 4-year statute of limitation is calculated from the date on which the party knows or ought to know that its rights are infringed. This provision is purposed to match the 4-year requirement of the United Nations Convention on the Limitation Period in the International Sale of Goods.[76]

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[76] The Limitation Convention entered into force on August 1, 1988. The Convention determines "when claims of a buyer and a seller against each other arising from a contract of international sale of goods or relating to its breach, termination or invalidity can no longer be exercised by reason of the expiration of a period of time" (art. 1). Under the Convention, the "limitation period" is four years (art. 8).

In China, there are three different statute of limitations under the 1986 Civil Code, namely the general limitation, special limitation and ultimate limitation. The general limitation is the two-year statute of limitation and applies to all civil matters except otherwise provided by law. The special limitation is the statutory time limit that falls within the category of "otherwise provided by law". In addition to the contracts for international sale of goods and transfer of technology to which the 4-year time limit is applied, there are several civil actions that have only one-year time limit. The one-year statute of limitation under the Civil Code applies to: (a) claims for compensation for bodily injuries, (b) sales of substandard goods without proper notice to that effect, (c) delays in paying rent or refusal to pay rent, or (c) losses or damages to the property left in the care of another person.[77]

The Contract Law, however, modifies the one-year statute of limitation as applied to the sales of substandard goods. According to Article 158 of the Contract Law, with regard to sales of goods, (a) if there is no agreement between the parties in the contract on the inspection period, the buyer shall make a notice to the seller within a reasonable period of time after it finds or ought to find that the quantity or quality of the goods do not conform with the terms of the contract; if the buyer fails to make the notice as such within the reasonable time period or within two years from the date of the receipt of the goods, it shall be assumed that the quantity or quality of the object has conformed with the terms of the contract; (b) if there is a quality guaranty period, such guaranty period shall be applied in lieu of the two-year limit; (c) if the seller knows or ought to know the goods to be supplied do not conform with the terms of the contract, the buyer is not subject to the time limit of the notice.[78]

The ultimate limitation refers to the maximum time period for making a civil claim, and the time period as prescribed in the 1986 Civil Code has a 20-year limit from the date of infringement of the right.[79] The 20-year statute of limitation applies to all civil claims regardless of whether the aggrieved party knows or ought to know the damages or infringement. However, under special circumstances, the people's court may at its discretion extend the period of the statute of limitation. According to the Supreme People's Court, the "special circumstances" would cover the cases in which the claimant could

[77] See the Civil Code, art. 136.
[78] See the Contract Law, art. 158.
[79] See Civil Code, art. 137.

not exercise his right during the statute of limitation because of the "objective reasons".[80]

But, the statute of limitation may be suspended or tolled, excluding the extended period under the "special circumstances". If during the last six moths of the time limitation, the claimant is unable to exercise the right to make the claim due to *force majeure* or other obstacles, the statute of limitation for this particular claim shall be suspended, but will resume on the day when the circumstances for the suspension are removed.[81] The "other obstacles" are interpreted by the Supreme People's Court to include the situation where claimant is lack of the capacity for civil conduct or has limited civil capacity (a) without agent *ad litem*, or (b) with an agent *ad litem* who is dead or, no longer has the power of attorney, or has lost capacity himself for civil conduct.[82]

The statute of limitation will be tolled if any of the following three situations takes place: (a) the claimant (creditor) brings a lawsuit, (b) the claimant makes a claim to the debtor, or (c) the debtor agrees to fulfill the obligation. At the time of toll, the statute of limitation starts all over again.[83] With regard to making a claim, it does not have to be made to debtor himself, a claim made by the claimant to the guarantor, the agent, or administrator/receiver of the property of the debtor will satisfy the requirements for the toll.[84] In addition, the statute of limitation will also be tolled when the claimant makes a petition to the local people's mediation committee or relevant authority for the protection of his civil rights.[85]

There seems to have been a problem in determining the matter of "ought to know" because it would require more analysis on a case-by-case basis. In regard to the contracts, the Supreme People's Court has developed from the practice a guideline that is aimed at helping deal with the "ought to know" issue. According to the Supreme People's Court, "ought to know" may be determined differently under the following circumstances: (a) if the contract claim is attached with condition or time limit, the limitation runs from the time that condition is met or the time limit is up; (b) if the contract has a time for performance, the limitation begins to count from the expiration of the time; (c) if there is no performance time period, the limitation runs from the time the

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[80] See Supreme People's Court, the 1988 Opinions on Several Matters Concerning Application and Implementation of the General Principles of Civil Law of China (Provisional), art. 169 (hereinafter referred to as Opinions).

[81] See Civil Code, Art. 139.

[82] See Supreme People's Court, *Opinions, supra* note 80, art. 172.

[83] See Civil Code, Art. 140.

[84] See Supreme People's Court, *Opinions, supra* note 80, art. 173.

[85] See *id*., art. 174.

claimant may make a claim; (d) if there is a claim for restitution after the contract is void or rescinded, its limitation is calculated from the time of the voidance or rescission of the contract; (e) if the object of the contract is "not-to-act" (means a passive obligation), the limitation is counted from the time the obligation of not-to-act is violated; or (f) if there is a claim for continuing performance, damages or liquidated damages due to a breach of contract, the limitation runs from the time of the breach.[86]

[86] See Li Guoguang, *supra* note 8 at pp. 596–598.

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