

# ARTICLES

## CHINA'S UNIFORM CONTRACT LAW: PROGRESS AND PROBLEMS

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### I. INTRODUCTION

Although China decided to adopt a market-oriented economy in the early 1990s, its contract law system remained unsatisfactory. The numerous provisions on governmental intervention in the 1993 amendments to the Economic Contract Law of the PRC (ECL)<sup>1</sup> indicate that the reforms were incomplete.<sup>2</sup> Problems still exist in numerous areas.<sup>3</sup> First, party autonomy is quite limited. The law of contracts is quite paternalistic and the room for intervention is unnecessarily large. Second, the contract laws do not cover a wide sector of economic activities between individuals or between individuals and legal persons. Third, the provisions in the various contract laws are insufficiently detailed. This creates difficulties not only for contractual parties in guiding their transactions but also for courts in handling cases. Fourth, the differential treatment of civil contracts

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1. See REVISIONS TO THE ECONOMIC CONTRACT LAW, Fagui Huibian [Collection of the Laws of the PRC](1993).

2. For instance, the revised ECL still allowed the state to impose mandatory plans on enterprises. See *id.* art. 11. Also, product quantity shall be measured in accordance with state regulations if State-imposed standards exist. See *id.* art. 17(1). Stipulated product quality requirements and packaging quality requirements may not be less stringent than mandatory state or industry standards if such standards exist. See *id.* art. 17(2). The parties shall only set prices of products in the absence of state prices. See *id.* art. 17(3)).

3. Zhang Guangxing, *Zhonghua Renmin Gongheguo Hetongfa de Qicao*, FA XUE YAN JIU, at 3, 4 (1995).

and economic contracts, as well as domestic economic contracts and foreign economic contracts, remains. This differential treatment is not consistent with China's goal of establishing a market-oriented economy and integrating it with the world economy.

Against this backdrop, China attempted to unify its contract laws by enacting a uniform contract law in 1993.<sup>4</sup> After about six years of drafting, the NPC adopted the Contract Law of the PRC (Uniform Contract Law or Contract Law) on March 15, 1999. The Contract Law will come into effect on October 1, 1999. The Contract Law aims to achieve many goals. In order to move towards a market-oriented economy and to integrate with the world economy, the Uniform Contract Law abolishes the differential treatment between civil contracts and economic contracts and between domestic economic contracts and foreign economic contracts. The Contract Law is based on experience from the spheres of Chinese economic and judicial practice as well as relevant experience from other countries. The Contract Law also attempts to substantially enlarge the contractual freedom of the parties. Restrictions on freedom of contract must be clearly justified. Moreover, the law has taken into account different values in contract law. These values include economic efficiency and social justice. Technically speaking, this Contract Law is relatively detailed and is more operational than any past versions.

This article consists of five sections including this introduction. Section II will explore the historical background of China's contract law. Section III will examine the major progress made in the Contract Law. Section IV will discuss the problems existing in the Contract Law. Conclusions follow in Section V.

## II. HISTORICAL BACKGROUND OF THE LAW OF CONTRACTS

China's contract law was and still is shaped by the economic reform policy. From 1949 to 1956, China gradually nationalized and collectivized the private sector.<sup>5</sup> Between 1958 and 1978, the

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4. It is generally accepted that the drafting process of China's uniform contract law began in 1993. *See id.* *See also* ZHONG JIANHUA & MARK WILLIAMS, FOREIGN TRADE CONTRACT LAW IN CHINA 18 (1998). For a detailed discussion of the drafting process of China's uniform contract law, see Ping Jiang, *Drafting the Uniform Contract Law in China*, 10 COLUM. J. ASIAN L. 245-6 (1996).

5. This is called "socialist transformation" in China, by which is meant the gradual nationalization of private business which took place in China between 1954 and 1956. For detailed discussion of this issue, see CHENG YUAN, EAST WEST TRADE: CHANGING PATTERNS IN CHINESE FOREIGN TRADE LAW AND INSTITUTIONS 48-51 (1991). *See also* RALPH H. FOLSOM ET AL., LAW AND POLITICS IN THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL 27-28 (1992).

Chinese economic system was based on a planned model. Within such an economy, the decision-making power for the allocation of productive resources was concentrated in the hands of the State. While the market still existed, currency-commodity relations<sup>6</sup> remained, and various targets were realized through mandatory plans drawn up by the state hierarchy. The enterprise immediately responsible for production had to follow state orders in business activities, such as finance, management, marketing, employment, wage policy, and expansion, and consequently enjoyed hardly any independence. Within this system, the role of contract law was very limited.

The earliest PRC contract law was reflected in the Provisional Rules Regarding Contracts among Governmental Organizations, State-Owned Enterprises and Collective Units in 1950.<sup>7</sup> In the same year, the Ministry of Trade issued a decision Concerning the Strict Implementation of Contracts.<sup>8</sup> These regulations subjected a great number of important contracts to state planning. The planning nature of these regulations, of course, did not mean that the institution of contract was dead. Contractual exchanges still existed for personal consumption items in cities or towns and for mutual assistance in the construction of houses in rural areas. The rights and obligations of the parties and dispute resolution arising in these contractual exchanges were, to a large extent, based on custom and relations. There did not exist a comprehensive contract law system, not to mention any formal application of contract law.

The development of contract law was no better in the 1960s than it had been in the 1950s. In 1962, the Communist Party Central Committee and the State Council jointly issued their Notice Regarding Strict Implementation of Basic Construction Procedure and Economic Contracts.<sup>9</sup> In 1963, the Interim Regulation on Contract for Ordinary Industrial and Mineral Products was issued by the National Economic Committee.<sup>10</sup> Contracts in the 1960s were mainly treated as an instrument to fulfill the State's economic planning. The drafting of a few major laws such as the civil law, criminal law and the maritime law was abandoned in 1966 when Mao Zedong launched the Cultural

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6. Although the State planned production of most end goods or services, these goods or services were not directly allocated to individuals. Instead, these goods or services were exchanged through the medium of money on the market.

7. See JINGJI HETONG FA SHOUCHE 27-28 (Wang Zhong et al. eds., Jilin University Press, 1994).

8. See *id.* at 32.

9. See *id.* at 192-93.

10. This Interim Regulation was replaced by the Regulation on Contracts for the Sale of Industrial and Mineral Products issued by the State Council in 1984.

Revolution. The Cultural Revolution (1966-1976) witnessed the dismantling of the then-existing rudimentary legal system, including the substantive contract law.

From 1978 to the enactment of the Contract Law, Chinese contract law has developed relatively rapidly. The Third Plenum of the Eleventh Central Committee of the Chinese Communist Party held in 1978 dramatically changed China's policy direction. Under Deng Xiaoping's influence, China's closed economy has changed to an open one that began emphasizing the division of labor. China shifted from a planned economy under the control of centralized management, to a commodity economy geared to planned development, and finally in 1993 to a market-oriented economy. The reduction of the role of economic planning has increased the role of voluntary contractual exchanges. The increasing role of contractual exchanges, in turn, has required improvements in the institution of contract.

In 1981, China enacted the Economic Contract Law (ECL).<sup>11</sup> In 1985, China adopted the Foreign Economic Contract Law (FECL).<sup>12</sup> The years 1986 and 1987 witnessed another two major pieces of law. One was the General Principles of Civil Law (GPCL)<sup>13</sup> The other was the Technology Contract Law (TCL).<sup>14</sup> These major pieces of law, together with administrative regulations promulgated by the State Council and various ministries, along with judicial interpretation issued by the Supreme People's Court, established a basic framework of contract law at the national level.

The law of contract in this period reflected both market transactions and planned allocation of resources by the State. Thus, contracts in this period were initially divided into civil contracts and economic contracts. Civil contracts basically dealt with consumer transactions, while economic contracts governed transactions relating to productive resources. Economic contracts were further divided into domestic economic contracts and foreign economic contracts. Domestic economic contracts reflected certain elements of economic planning and covered economic contracts in which contractual parties were domestic persons. In contrast, foreign economic contracts dealt with contracts where one of the parties was a foreigner, the basic ration-

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11. See ECONOMIC CONTRACT LAW [ECL], Fagui Huibian [Collection of the Laws of the PRC](1981).

12. See FOREIGN ECONOMIC CONTRACT LAW [FECL], Fagui Huibian [Collection of the Laws of the PRC](1985).

13. See GENERAL PRINCIPLES OF CIVIL LAW [GPCL], Fagui Huibian [Collection of the Laws of the PRC](1986).

14. See TECHNOLOGY CONTRACT LAW [TCL], Fagui Huibian [Collection of the Laws of the PRC](1987).

ale being that China's economic planning could not be extended beyond its national boundary. Therefore, international business practice had to be closely followed in foreign economic contracts.

The ECL applied to contracts concluded between legal persons, other economic organizations, individual industrial and commercial households, and rural contracting households of equal status to achieve certain economic goals by defining mutual rights and obligations.<sup>15</sup> Traditionally, economic contracts were used to allocate productive resources to fulfill State economic planning. In rigid socialist countries, productive resources were nationalized. It was impossible for individuals to become contractual parties in economic contracts. When the ECL became effective in 1981, an economic contract was defined as an agreement between legal persons to achieve certain economic objectives by specifying their corresponding rights and obligations. As China's new economic policy adopted at the end of 1970s began to permit domestic private individuals and foreign investors to participate in the production process, the 1981 ECL became quite incompatible with prevailing economic reality. In addition, economic policy at the beginning of the 1990s favored a market-oriented economy. For this reason, the 1981 ECL was considerably amended in 1993, although the amendments can not be said to have been complete to the extent that the amended law was still planning oriented. Since its amendment, the ECL has applied to contracts where both parties are legal persons, other economic organizations, individual business households, and rural leaseholding households.<sup>16</sup> The purpose for entering into economic contracts is to clarify each party's rights and obligations so as to realize certain economic objectives.<sup>17</sup> Under this definition as well as article 46 of the ECL, the ECL does not govern certain contracts. These contracts include ordinary consumer contracts where one party acquires goods or services for personal consumption or use, foreign economic contracts where one of the parties is a foreigner, and technology contracts where the parties are dealing with the development, transfer, consultation or service of technology.

Compared with civil contracts, under the ECL economic contracts possess their own characteristics. First of all, economic contracts are subject to severe state intervention. If the state issues mandatory plans to enterprises in accordance with its requirements, the enterprises concerned shall sign the contracts based on the rights and obligations of the enterprises as pre-

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15. See ECL art. 2.

16. See *id.*

17. See *id.*

scribed in the relevant laws or administrative regulations.<sup>18</sup> If an economic contract is intended to harm the state or societal interest, the properties these parties have acquired or may acquire under the contract shall be confiscated and put into the state treasury.<sup>19</sup> Moreover, the price and quality of contractual goods may be subject to State regulation.<sup>20</sup> In addition, economic contracts are subject to supervision by the State Administration for Industry and Commerce and other relevant competent departments at various levels.<sup>21</sup> Unlike the resolution of civil contract disputes where the parties may submit their disputes to People's mediation committees or the courts, resolution of economic contract disputes has to be dealt with by the arbitration tribunals within the State Administration for Industry and Commerce. If the court is involved, civil contract disputes are handled by the civil division, whereas the economic division deals with disputes over economic contracts.<sup>22</sup>

By negative implication, civil contracts related to personal consumption, barter, gifts, agency or trust are excluded from the application of the ECL. Civil contracts are governed by the GPCL.<sup>23</sup> As the GPCL only contains a few brief provisions relating to contracts, the Supreme People's Court issued the Opinions on Several Issues Concerning the Implementation of the General Principles of Civil Law (for provisional use) (GPCL Opinions).<sup>24</sup> While clarifying certain issues, the GPCL Opinions still left many issues unanswered. When the law does not provide either mandatory provisions or enabling rules, the views of scholars as well as practices relating to contractual negotiation, drafting, and dispute resolution fill the gaps. Further, fundamental principles become more important.

The Foreign Economic Contract Law (FECL) governs foreign economic contracts.<sup>25</sup> The FECL contains some brief principles that are fairly consistent with international business practice.

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18. See *id.* art. 11.

19. See *id.* art. 16(2).

20. See *id.* art. 17.

21. See *id.* art. 44.

22. Civil cases are dealt with by civil division and economic cases by economic division in a court. See THE ORGANIC LAW OF THE PEOPLE'S COURTS OF THE PEOPLE'S REPUBLIC OF CHINA arts. 19, 24, 27, 31, Fagui Huibian [Collection of the Laws of the PRC] 47 (1949-1989).

23. See GPCL art. 2 (stating that the GPCL deals "with property relationships and personal relationships between civil subjects with equal status, that is, between citizens, between legal persons and between citizens and legal persons.").

24. See Zui Gao Renmin Fayuan [Supreme People's Court], *Zhonghua Renmin Gongheguo Minfa Tongze Ruogan Wenti de Yijian (Shixing)*, in ZHONGHUA RENMIN GONGHEGUO FALÜ QUANSHU 350, 355 (Wang Huai'an et al. eds., Jilin People's Press 1988)[hereinafter *GPCL Opinions*].

25. See FECL art. 2; See also ECL art. 46.

When these proved not sufficiently detailed, the Supreme People's Court issued the Answers to Certain Questions Concerning the Application of the Foreign Economic Contract Law (The FECL Answers).<sup>26</sup> Related to these legal provisions is the United Nations Convention on Contracts for the International Sale of Goods (CISG).<sup>27</sup> Where Chinese laws are in conflict with international treaties to which China is a signatory or party, the international treaty shall apply, except where China has made reservations.<sup>28</sup>

Similar to domestic economic contracts, foreign economic contracts are also not well defined under Chinese law. The FECL only provides that the law applies to economic contracts concluded between enterprises or other economic organizations of China and foreign enterprises, other economic organizations or individuals.<sup>29</sup> The FECL Answers has construed the FECL to also include the following economic contracts so long as these contracts are concluded or performed in China: (1) economic contracts concluded between enterprises, other economic organizations and individuals from Hong Kong and Macao and mainland enterprises and other economic organizations; (2) economic contracts concluded between foreign enterprises, other economic organizations and individuals; (3) economic contracts concluded between enterprises, other economic organizations, and individuals from Hong Kong or Macao and (4) economic contracts concluded between foreign enterprises, other economic organizations, and individuals and enterprises, other economic organizations, and individuals from Hong Kong or Macao.<sup>30</sup> However, international transport contracts are excluded.<sup>31</sup> Hence, the FECL is relevant to the sale of goods, equity joint venture contracts, contractual joint venture contracts, contracts for the joint exploration of natural resources, loan contracts, leasing contracts, technology transfer contracts, guarantee contracts, processing contracts, agency contracts, countertrade contracts, etc.<sup>32</sup> However, contracts entered into between joint

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26. See Zui Gao Renmin Fayuan [Supreme People's Court], *Guanyu Shiyong "Shewai Jingji Hetong Fa" Ruogan Wenji Jieda*, in QUANGUO LÜSHI ZIGE KAOSHI BIDU FALÜ FAGUI HUIBIAN 1164 (Chinese Lawyers Qualifications Testing Center ed., Chinese Political University Press 1994)(1987)[hereinafter *FECL Answers*].

27. China ratified this Convention on 11 December 1986. The Convention went into effect on 1 January 1988. See U.N. Doc. A/Conf. 97/18, *reprinted in* 19 INT'L LEGAL MATERIALS at 668-99 (1980)[hereinafter *CISG*].

28. See FECL art. 6.

29. See FECL art. 2.

30. See *FECL Answers* art. 1(2).

31. See FECL art. 2.

32. See *FECL Answers* art. 1 (1).

ventures and other Chinese entities are governed by the ECL, as joint ventures are Chinese entities once incorporated in China.<sup>33</sup>

Technology contracts are also divided into domestic contracts and contracts for the importation of technology. The former are governed by the TCL<sup>34</sup> whereas the latter contracts are governed by the FECL and the Administrative Regulation for the Importation of Technology.<sup>35</sup>

An interesting point is that neither the ECL nor the FECL defines the content of an economic contract although both have specified the eligibility of contractual parties. The term economic contract was borrowed from the Soviet Union.<sup>36</sup> Three basic criteria were adopted to distinguish civil contracts and economic contracts. The first criterion is the eligibility of the parties to enter into economic contracts. According to this criterion, only legal persons are allowed to own and transfer productive resources to fulfill the state's economic planning goals. Individuals are excluded from economic contracts. Naturally, the 1981 ECL only applied to contracts between legal persons. Even the 1993 amended ECL restricted its application to contracts between legal persons, economic organizations, and individual industrial and commercial households and rural contracting households. This criterion is not satisfactory in the sense that legal persons may enter into contracts to purchase consumer goods for their employees. Moreover, this criterion has already become inconsistent with the market-oriented economic principles adopted by China in recent years. In a market economy, everyone is theoretically allowed to own productive resources to engage in trade. The second criterion is related to planning. Judged by this criterion, economic contracts are to achieve state economic planning. This criterion is now totally out of date. The third criterion focuses on economic objectives. Evaluated by this criterion, the purpose of economic contracts is to increase production. Thus, personal consumption contracts are excluded. This criterion is also not satisfactory. The further ends of production may be consumption. Consumption and production are closely integrated in the wealth creation process. To divide the process of consumption and production is meaningless. In addition, the same contractual materials may be partly used for consumption and partly for production. It was these reasons that led to the abandonment

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33. See *FECL Answers* art. 1(3).

34. See ECL art. 46; See also TCL art. 2.

35. See ADMINISTRATIVE REGULATION FOR THE IMPORTATION OF TECHNOLOGY, Fagui Huibian [Collection of the Laws of the PRC](1985); FECL art. 2.

36. See WANG LIMING & CUI JIANYUAN, HETONG FA XIN LUN-ZONG ZE 7-11 (1996).

of the earlier concept of economic contract in the Uniform Contract Law.

The Uniform Contract Law enacted in 1999<sup>37</sup> reflects China's significant policy change. As China has moved to a market-oriented economy, the differential treatment between civil contracts and economic contracts and between domestic economic contracts and foreign economic contracts is no longer sustainable. For instance, a foreign incorporated company may choose to trade with Chinese companies without moving its factory to China. Alternatively, the foreign company may choose to trade with Chinese companies by setting up a Chinese incorporated company in China through direct foreign investment. In this example, no significant differences can be found in these transactions although in the former case the parties may choose the proper law governing their contract. Although there still exist some defects which will be analyzed in Section IV, this Contract Law shows considerable improvements in governing contractual transactions.

### III. PROGRESS MADE IN THE UNIFORM CONTRACT LAW

#### A. FREEDOM OF CONTRACT

The principle of freedom of contract has been recognized as one of the cardinal principles of the Contract law.<sup>38</sup> Article 4 of the Contract Law provides that the parties to a contract shall comply with the principle of voluntary participation; no party shall compel others to accept its will and no individuals or organizations shall unlawfully intervene. This article represents significant progress and is of pivotal importance in China's transition towards a market-oriented economy. In the planned economy of years past, major economic decisions were made from the top. Although China has moved to a market economy, administrative institutions still have the inclination to interfere with enterprises, particularly state-owned enterprises, in their business decisions. The freedom of contract provision provides legal means to resist such intervention. In order to reflect the principle of freedom of contract, the Contract Law extends the concept of contract. According to the Contract Law, a contract is defined as an agreement whereby the parties establish, change or terminate civil relationships between individuals, legal persons

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37. The entire Chinese language text, with parallel English translation, appears in the May, 1999 issue of CHINA LAW & PRACTICE. See *PRC, Contract Law*, CHINA LAW & PRACTICE, May 1999, at 19 [hereinafter *Contract Law*].

38. See Wang Liming, *Tongyi Hetong Fazhi Dingzhong de Ruogan Yinan Wenti Tanta* (*shang*), ZHENG FA LUN TAN, Aug. 1996, at 50.

and other organizations of equal standing.<sup>39</sup> Based on Article 85 of the GPCL, this definition first abolishes the distinction between civil contracts and economic contracts.<sup>40</sup> Also, this definition has extended the contractual capacity to individuals. In the past, both the ECL<sup>41</sup> and the FECL<sup>42</sup> failed to recognize the contractual capacity of individuals to enter into economic contracts or foreign economic contracts. Although the FECL allows foreign individuals to be parties to foreign economic contracts, Chinese individuals are not competent to become parties to foreign economic contracts.

Like the GPCL, the Contract Law also contains some general principles. General principles refer to those principles that shape the contract law in the areas of drafting, interpretation, and enforcement. These principles include equality, fairness, and bargaining in good faith. The principles of equality<sup>43</sup> and fairness<sup>44</sup> are still found in the Contract Law. Equality is an important fundamental principle. Parties shall have equal status in civil activities.<sup>45</sup> A contract shall be the result of a voluntary bargain. Since contractual parties are under equal protection of law, no party is allowed to impose its will upon the other.<sup>46</sup> However, a difference does exist between the GPCL and the Contract Law in this aspect. Under the GPCL, contracts entered into under coercive circumstances are automatically void<sup>47</sup>, while such contracts are categorized as voidable in the Contract Law.<sup>48</sup> To reduce the scope of void contracts is an important indicator of recognition of the principle of freedom of contract, which will be discussed in detail later in this Section.

The Contract Law has also managed to reduce governmental intervention to a minimum. For instance, an enabling rule is inserted in the Contract Law to fill the gap left by contractual parties related to quality, price, and place of performance.<sup>49</sup> In

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39. See *Contract Law* art. 2.

40. See GPCL art. 85 (stating that a contract shall be an agreement whereby the parties establish, change or terminate their civil relationship).

41. The ECL has only been applied to contracts between legal persons, other economic organizations, individual industrialists and merchants, and rural business contractors that are of equal civil legal subjects, which specify their mutual rights and obligations in order to realize a definite economic objective. See ECL art. 2.

42. The FECL applies to economic contracts concluded between enterprises or other economic organizations of the PRC and foreign enterprises, other economic organizations or individuals. See FECL art. 2.

43. See *Contract Law* art. 3.

44. See *id.* art. 5.

45. See GPCL art. 3.

46. See *Contract Law* art. 3.

47. See GPCL art. 58 (3).

48. See *Contract Law* art. 54.

49. See *Contract Law* art. 61.

accordance with that rule, the parties to a contract may add provisions afterwards if no provisions exist or if the provisions are unclear on price, quality, and place of performance.<sup>50</sup> If no clarification can be made through agreement, the gap may be filled by adopting trade practice or applying related contractual provisions.<sup>51</sup> If these methods fail, the Contract Law provides for more flexible standards to determine the quality and the price. If the quality is unclear, the prevailing state or industry standard shall be applied; if no state or industry standard exists, the average standard or specific standard consistent with the realization of contractual goals applies.<sup>52</sup> This provision is slightly different from that of the GPCL. The GPCL provision states that if quality requirements are unclear, state quality standards shall apply; if there are no state quality standards, the generally held standard shall apply.<sup>53</sup> Under the Contract Law, if the price is unclear, the market price at the time of contracting and at the place of performance shall be followed unless there exists a state regulated or guided price.<sup>54</sup> However, under the GPCL, if the price is unclear, the state-fixed price shall apply. If there is no state-fixed price, the price shall be based on market price or the price of a similar article or remuneration for a similar service.<sup>55</sup>

## B. FORMATION OF CONTRACT

One of the achievements the Contract Law has made is the addition of legal provisions on offer and acceptance. According to the Contract Law, an offer is an expression of intention to enter into a contract.<sup>56</sup> The content of the offer must be certain and a contract forms upon acceptance of the offer.<sup>57</sup> Unfortunately, the law does not mention the consequences of uncertainty. Does uncertainty in the content of the offer result in a non-effective contract? If that is the case, what is the purpose of having Article 61 and 62? Article 61 says, *inter alia*, that if the price is not specified or not clearly specified, the parties may add provisions related to price ex-post-facto. If no agreement on price can be reached after the formation of contract, industry custom may determine the price. Failing that, the State-regulated price shall be applied. Where there is no State-regulated price, the market price at the time of contracting and at the place

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50. *See id.*

51. *See id.*

52. *See id.* art. 62(1).

53. *See* GPCL art. 88 (1).

54. *See Contract Law* art. 62(2).

55. *See* GPCL art. 88 (4).

56. *See Contract Law* art. 14.

57. *See id.*

of performance applies.<sup>58</sup> Notably, Article 61 does not mention the subject matter of contract or quantity. Therefore, it is possible that lack of terms on the subject matter and on quantity will affect formation of contract. The provision on uncertainty is, however, not that significant. In virtually all transactions, the subject matter of contract is relatively clear. The quantity may be unclear in contracts with long-term relations, but people with long-term relations are more likely to adjust their relations and solve disputes in friendly ways.

An offer becomes effective when it reaches the offeree. It may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer.<sup>59</sup> Similar to the CISG but unlike the previous law, an offer may be revoked if the revocation reaches the offeree before he has dispatched an acceptance.<sup>60</sup> However, an offer cannot be revoked: (i) if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or (ii) if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer.<sup>61</sup> An offer is terminated when a rejection reaches the offeror.<sup>62</sup>

An acceptance is an expression indicating assent to an offer. An acceptance shall be made expressly unless the parties agree otherwise or customary practice is different.<sup>63</sup> An acceptance must reach the offeror within the period specified in the offer.<sup>64</sup> If no period for acceptance is specified in an offer, acceptance must be made according to the following: for oral offers, acceptance must be made right away unless the parties agree otherwise;<sup>65</sup> where an offer is not orally made, acceptance shall reach the offeror within a reasonable period.<sup>66</sup>

An acceptance dispatched outside the offer period results in a new offer unless the initial offeror promptly notifies the offeree of the validity of the acceptance.<sup>67</sup> With respect to an acceptance sent within the offer period that reaches the offeror outside the offer period, the offeror has the option either to recognize the acceptance or to reject the acceptance. In the latter case, the offeror has to give prompt notice to the offeree or the acceptance is

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58. *See id.* art. 62 (2).

59. *See id.* art. 17.

60. *See id.* art. 18.

61. *See id.* art. 19.

62. *See id.* art. 20 (2).

63. *See id.* art. 22.

64. *See id.* art. 23.

65. *See id.*

66. *See id.*

67. *See id.* art. 28.

treated as within the offer period.<sup>68</sup> Any non-substantive amendment of the offer by an acceptance does not affect the validity of the acceptance unless the offeror immediately objects or unless the offer specifies clearly that the content cannot be varied.<sup>69</sup> The content of the acceptance rather than the offer prevails if the amendment is substantive.<sup>70</sup>

A material variation to the content of the offer is a counter-offer. Any addition or variation of the major terms, including the subject matter, quantity, quality, the price, place, time and methods of performance, liability for breach and method of resolving disputes is considered to be a material variation.<sup>71</sup> Unless custom or the offer indicates otherwise, the offeree must notify the offeror of the acceptance.<sup>72</sup> If an offeree has to notify the offeror of an acceptance, the acceptance becomes effective at the time when it reaches the offeror.<sup>73</sup> Similar to the CISG, an acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance reaches the offeror.<sup>74</sup> A contract is entered into when an acceptance becomes effective.<sup>75</sup> The place where an acceptance becomes effective is the place the contract is concluded.<sup>76</sup>

With respect to the form of a contract, the ECL imposes strict requirements. Under the ECL, economic contracts must be in writing except those that are performed immediately after the formation of contract.<sup>77</sup> Economic contracts between legal persons<sup>78</sup> are signed by legal representatives.<sup>79</sup> Contractual obligations and other liabilities resulting from operational activities undertaken by legal representatives or others shall be borne by the legal persons.<sup>80</sup> The FECL's requirements are equally strict. Under the FECL, a foreign economic contract emerges when the parties sign a written contract.<sup>81</sup> If letters, telegrams or telexes provide the medium of communication, and one party requests a

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68. *See id.* art. 29.

69. *See id.* art. 31.

70. *See id.*

71. *See id.* art. 30.

72. *See id.* art. 22.

73. *See id.* art. 26.

74. *See id.* art. 27.

75. *See id.* art. 25.

76. *See id.* art. 34.

77. *See* ECL art. 3.

78. *See* GPCL art. 37 (stating that “[a] legal person shall have the following qualifications: (i) establishment in accordance with the law; (ii) possession of the necessary property or funds; (iii) possession of its own name, organization and premises; and (iv) ability to independently bear civil liability.”).

79. *See id.* art. 38.

80. *See id.* art. 43.

81. *See* FECL art. 7.

signed letter of confirmation, the signature on the confirmation letter forms the contract.<sup>82</sup> In practice, faxes often serve this purpose. Although the CISG permits oral contracts,<sup>83</sup> China took a reservation that requires foreign economic contracts to be in writing. Under the FECL, contracts that are subject to the approval of governmental agencies, as provided for by law or administrative regulations, are formed upon grant of approval.<sup>84</sup> Generally, most foreign economic contracts including Sino-foreign equity joint venture contracts, Sino-foreign co-operative joint ventures contracts, technology transfer contracts, and Sino-foreign joint oil exploration contracts are subject to approval.

However, the Contract Law imposes much more flexible requirements on contractual form. Thus, contracts may be oral, in writing or in other forms.<sup>85</sup> Nevertheless, it requires that a contract must be in writing if the law and regulations require or if the parties have so specified.<sup>86</sup> Writing may take the form of contracts on papers, letters and electronic messages including telegrams, telexes, faxes, electronic interchange of data and electronic mail.<sup>87</sup> This flexible interpretation of the form of writing "lays the foundation for the development of a legal structure to support electronic commerce (e-commerce)".<sup>88</sup>

Another improvement of the Uniform Contract Law over the previous contract law is the provision on standard form contracts. The Uniform Contract Law imposes two obligations on the party providing the standard form contract. One is the duty to observe the fairness principle in specifying the rights and obligations of the parties. This is similar to the unconscionability doctrine or the reasonableness doctrine in the West. The other duty of the party adopting the standard form contract is to notify the other party of any exemption or limitation clauses in the contract.<sup>89</sup>

Certain standard clauses are not valid. They include clauses with malicious collusion intended to harm the social or public interest, and clauses that violate laws or administrative regulations.<sup>90</sup> Further, clauses exempting from liability intentional, reckless, or negligent conduct and clauses excluding liability for

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82. *See id.*

83. *See* CISG art. 11.

84. *See* FECL art. 7.

85. *See Contract Law* art. 10.

86. *See id.* art. 10.

87. *See id.* art. 11.

88. Volker Pasternak, *Contract Law Lays Foundation for E-commerce*, CHINA LAW & PRACTICE, April 1999, at 53.

89. *See Contract Law* art. 39.

90. *See id.* art. 40, 52.

personal injuries are null and void.<sup>91</sup> Additional invalid clauses are those exempting a party's fundamental obligations in a contract or excluding the other party's fundamental rights.<sup>92</sup> The above clauses reflect the paternalistic position of the drafters. Chinese law on contracts has not reached a level that allows parties complete freedom, and uses the unconscionability principle to examine whether the limit of freedom of contract has been reached. This may be appropriate given that the judiciary is not very mature or sophisticated.

From an interpretative perspective, the Uniform Contract Law states that standard clauses should be interpreted according to the understanding of ordinary people.<sup>93</sup> In case a standard clause is not clear, it should be interpreted against the person providing the standard clause.<sup>94</sup> Where there is inconsistency between standard clauses and non-standard clauses, the non-standard clauses should be adopted.<sup>95</sup>

### C. VALIDITY OF CONTRACTS

The parties to a contract may include conditions.<sup>96</sup> If a contract contains a condition precedent, the contract becomes valid when the condition precedent materializes. On the other hand, if a condition subsequent exists in a contract, the contract comes to an end when the condition subsequent materializes.<sup>97</sup> Any self-interested intentional attempt to promote or prevent the materialization of conditions will be void.<sup>98</sup> Contracts may also include terms on time period.<sup>99</sup> The starting time means the effective date of a contract. The ending time refers to the termination date of a contract.<sup>100</sup>

Contracts entered into by agents without authority in the name of a principal do not bind the principal unless the principal affirms the contract.<sup>101</sup> If the other interested party wants to keep the contract, it has to request affirmation from the principal within one month of the conclusion.<sup>102</sup> When the principal does not reply, the contract is deemed refused.<sup>103</sup> Before confirma-

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91. *See id.* art. 40, 53.

92. *See id.* art. 40.

93. *See id.* art. 41.

94. *See id.*

95. *See id.*

96. *See id.* art. 45.

97. *See id.*

98. *See id.*

99. *See id.* art. 46.

100. *See id.*

101. *See id.* art. 47.

102. *See id.*

103. *See id.*

tion, the interested party has the right to cancel the contract by express notice.<sup>104</sup> However, the agent's act may be considered valid despite the lack of authority if the other contractual party has reasonable ground to believe that the representative has the agency authority to sign the contract in the name of another.<sup>105</sup>

The Uniform Contract Law provides another important provision. That provision stipulates that contracts entered into by legal representatives or responsible persons on behalf of legal persons or other organizations are valid despite the lack of authority of these people unless the other contractual party is significantly negligent.<sup>106</sup> On the surface, it seems that this provision also affirms the position of the Supreme People's Court on the abolition of the ultra vires rule in China.<sup>107</sup> While contracts exceeding the registered scope of business may not be void per se, they may be invalidated if they violate other laws or regulations that restrict certain business activities. However, further examination reveals that this provision incorporates the internal irregularity rule in the West.<sup>108</sup>

Chinese contract law usually characterizes contracts as valid, void and voidable. Void contracts refer to contracts which violate laws and regulations and do not have any legal effect. Article 7 of the ECL provides that void contracts include contracts in violation of laws and administrative regulations, contracts concluded by fraud or duress, contracts signed by agents that fall outside of the scope of the agent's power, or contracts signed by agents with themselves or with any other person whom those agents represent.<sup>109</sup> Because the State Administration for Industry and Commerce (SAIC) at various levels is given the power to supervise economic contracts and handle contract disputes, it issued the Provisional Regulations Concerning the Determination and Handling of Void Economic Contracts (DHEC).<sup>110</sup> According to the DHEC, an economic contract is void if a party to the

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104. See *id.*

105. See *id.* art. 49.

106. See *id.* art. 50.

107. See Zui Gao Renmin Fayuan [Supreme People's Court], *Quanguo Jingji Shenpan Gongzuo Tanhui Jiyao*, in ZHONGHUA RENMIN GONGHEGUO FALU QUANSHU 137-43 (Wang Huai'an et al. eds., Jilin People's Press 1993)[hereinafter *Minutes*].

108. Under the internal irregularity rule, a person who deals in good faith with a company in a manner consistent with the company's public documents is entitled to rely on a presumption that all matters of internal management will comply with said documents. See *Royal British Bank v. Turquand*, 6 E & B 327, 119 Eng.Rep.886 (1856).

109. See ECL art. 7.

110. See PROVISIONAL REGULATIONS CONCERNING THE DETERMINATION AND HANDLING OF VOID ECONOMIC CONTRACTS [DHEC], Fagui Huibian [Collection of the Laws of the PRC] (1985).

contract is not eligible to enter into such a contract. Ineligible parties include persons who enter into a contract before obtaining a business license, units or departments of a legal person who conclude contracts in their own name, persons who sign contracts by using other persons' names without authorization, and persons who enter into contracts to conduct business beyond what is approved and registered.<sup>111</sup> The registered scope of business was considered very important in the past because non-compliance might jeopardize the planned economic system. In 1993, however, the Supreme People's Court changed its restrictive position. It instructed judges not to invalidate economic contracts only because the contracts go beyond the registered scope of business. An economic contract going beyond its registered scope of business still may be void on the ground that it has violated administrative regulations by entering into areas where special license or authorization is required.<sup>112</sup> For instance, if a company is not authorized to trade with foreign importers, its contracts for the importation of goods will be declared void. The reason for the change is that China has moved towards a market oriented economy since 1993. Therefore, the costs of adhering to the registered scope of business greatly exceed the benefits since too many contracts may be voided and creditors may face great uncertainty.

Contracts may also be determined void if the content is illegal.<sup>113</sup> Contracts entered into by fraud or duress are also void.<sup>114</sup> Fraud normally means the use of false information to induce another to sign a contract. Duress refers to one party coercing another to sign a contract against his true will by causing or threatening to cause harm to the other party, his property or family members. In addition, contracts for the sale of prohibited drugs are against law and public morality, and therefore are void.<sup>115</sup>

Void contracts also occur when the effect of agency activities does not give rise to legal rights.<sup>116</sup> If an agent acted without authorization, or beyond the scope of his authority, or after the termination of authority, the contract will be void.

The above discussion shows that the scope of void contracts is large. Scholars in China have already criticized the large scope of void contracts.<sup>117</sup> The large scope of void contracts shows pa-

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111. See *id.* art. 1(1).

112. See *Minutes*.

113. See ECL art. 7(1); DHEC art. 2.

114. See ECL art. 7(2).

115. See *id.* art. 7(4).

116. See ECL art. 7(3); DHEC art. 3.

117. See WANG & CUI, *supra* note 36.

ternalism in Chinese contract law. Annulling too many contracts causes uncertainty and denies the contractual parties the autonomy to decide for themselves. First, declaring too many contracts void is not consistent with wealth maximization if the parties can still benefit from these contracts and third parties rights are not affected. Second, invalidating too many contracts harms innocent third parties' interests when the rights in the original void contract have been transferred to an innocent third party. Third, paternalistic decisions may not reflect the will of the parties.<sup>118</sup> Instead, it is better to treat some void contracts—such as contracts signed by agents—as voidable. Similarly, it is more appropriate to give a party the option to affirm a contract entered into by misrepresentation.

Voidable contracts give one of the parties the option to keep the contract with the possibility of court ordered variation or rescission. A contract is voidable where the contract is obviously unfair to one party.<sup>119</sup> In such a case, the disadvantaged party has the right to petition the court or an arbitral tribunal to vary or rescind the contract.<sup>120</sup> Once declared void, voidable contracts have effects similar to void contracts. While the party to a voidable contract has the option, that party has to petition the court or an arbitration agency to alter or invalidate the contract.<sup>121</sup>

Void contracts shall have no legal effect from the very beginning.<sup>122</sup> If certain portions of an economic contract are declared invalid, those portions shall not affect the validity of the rest of the contract, and the rest shall remain valid.<sup>123</sup> Once an economic contract is declared invalid, the party that has acquired certain properties based on the contract shall return the properties to the other party.<sup>124</sup> The party at fault shall compensate the party that has suffered losses. If both parties are at fault for the losses, the two parties shall bear liability between them.<sup>125</sup>

If an economic contract is against State or public interests, and if both parties intend it, the property these parties have acquired or may acquire under the contract shall be confiscated and put into the State treasury.<sup>126</sup> If only one party has acted willfully, the willful party shall return the acquired goods back to

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118. *See id.*

119. *See* GPCL art. 59.

120. *See id.*

121. *See id.*

122. *See* ECL art. 7

123. *See id.*

124. *See id.* art. 16.

125. *See id.*

126. *See id.*

the other party, and the property acquired or to be acquired by the other party that has not acted willfully shall be turned over to the State.<sup>127</sup>

Similar to the ECL, the FECL's scope of declaring void contracts by the court is unnecessarily large. A few provisions in the FECL and the interpretation contained in the FECL Answers formulated by the Supreme People's Court cover a wide range of void contracts.

Under the FECL, contracts against the laws of the PRC or the public interests of society are void.<sup>128</sup> Contracts that cause harm to State sovereignty, injury to people's health and safety, or the deterioration of Chinese moral values are all considered contrary to public interests. Therefore, contracts for the importation of pornographic publications to China will be declared void.

Foreign economic contracts may also be declared void in the following cases: (i) the contractual parties are not legally qualified; (ii) a party in a foreign trade contract is not granted the right to engage in foreign trade; (iii) a Chinese contractual party exceeds the registered scope of business; (iv) approval of the contract is not obtained when required or approval for variation or assignment is not received if the original contract is subject to approval; (v) contracts not in writing; (vi) contracts entered into by agents who have not been authorized or have exceeded their authority and the principals do not ratify it.<sup>129</sup> Added to the above lists, contracts concluded by fraud or duress are void.<sup>130</sup> Fraud occurs where one party by means of cheating, concealing facts that should have been disclosed, or providing false impressions induces the other to sign the contract under a misunderstanding.<sup>131</sup> Duress exists where one party uses threat of economic loss or other harm to the other party to compel the latter to enter into a contract.<sup>132</sup> Duress also takes place when a party takes advantage of another's economic distress to conclude a contract.<sup>133</sup> Furthermore, a contract is void where the contracting parties maliciously conspire to harm the interests of the State, a collective, or a third party.<sup>134</sup>

Unlike void contracts, an innocent party to a voidable contract has the option either to affirm the contract or to request the court to rescind the contract. Although the FECL is silent on

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127. *See id.*

128. *See* FECL art. 9; *FECL Answers* art. 3(9).

129. *See FECL Answers* art. 3(1)-(6).

130. *See* FECL art. 10.

131. *See FECL Answers* art. 3(7).

132. *See id.*

133. *See id.*

134. *See id.* art. 3(8).

voidable contracts, the Supreme People's Court affirmed the position in Article 59 of the GPCL. Pursuant to the FECL Answers, a contract is voidable if it shows significant misconception or if it is obviously unfair.<sup>135</sup> Significant misconception exists where one party has a misconception with regard to the nature of the contract, the capacity of the other party, the type, quality, specification and quantity of the subject matter of the contract, or method, time and place of performance, so that the consequences of his conduct are against his intention and losses result.<sup>136</sup> Unfairness occurs where one party takes advantage of his position or the lack of experience of the other party to make a contract in which the rights and obligations of the two parties are arranged in a way that is obviously against the principles of fairness and the exchange of equivalent values.<sup>137</sup> The request to the court must be made within one year after concluding the contract.<sup>138</sup>

Once a party has decided to rescind the contract, a voidable contract has the effect of a void contract. It does not have any effect from the very beginning. However, if a contract is partly void and partly valid, the other part may be severed and valid if it can stand on its own.<sup>139</sup> Similar to civil contracts when declared void, the party at fault has to bear liability. If both parties are at fault, both are responsible for their respective fault.<sup>140</sup> Remedies normally include restitution and/or compensation for any necessary expenses incurred as a result of making and relying on a void or voidable contract. For instance, the party at fault will be asked to collect the goods and pay the transportation and storage costs incurred under the custody of the innocent party.

Compared with the contract law before 1999, the Uniform Contract Law enlarges the scope of voidable contracts. As stated previously, contracts formed by fraud or coercion are void under the old law. Now, an innocent party has the power to declare the contract void.<sup>141</sup> Voidable contracts also include contracts in which one of the parties entered based on a material misunderstanding<sup>142</sup> and contracts which are obviously unfair to one party.<sup>143</sup> The right to cancel these voidable contracts must be exercised within one year.<sup>144</sup> The right of cancellation will be

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135. *See id.* art. 4.

136. *See GPCL Opinions* §3(71).

137. *See id.* § 3(72).

138. *See id.* § 3 (73).

139. *See FECL Answers* art. 5(1).

140. *See id.* art. 5(2).

141. *See Contract Law* art. 54.

142. *See id.*

143. *See id.*

144. *See Contract Law* art. 55.

extinguished if it is not exercised within one year or if the innocent party affirms the contract.<sup>145</sup> Void contracts or cancelled voidable contracts have no legal effect from the beginning.<sup>146</sup> If a contract is partly void and partly valid and the void part does not affect the other parts, the other parts are still valid.<sup>147</sup> Even a voided contract will not affect the validity of the dispute resolution clauses therein.<sup>148</sup>

Void contracts have certain legal consequences. Any property received under a void contract must be returned.<sup>149</sup> If the property cannot be returned or it is impossible to return the property, the equivalent amount of money should be paid.<sup>150</sup> The guilty party shall compensate the other party for any losses suffered. If both parties are wrong, each shall bear its respective liability.<sup>151</sup>

#### D. CONTRACTUAL EFFECTS ON THIRD PARTIES

The Uniform Contract Law also contains provisions related to contractual effects on third parties. The parties to a contract may specify that the party owing an obligation may carry out the performance towards a third party.<sup>152</sup> The debtor shall be liable to the creditor for non-performance or improper performance.<sup>153</sup> It is also possible for the parties to agree that the obligations of the debtor be performed by a third party.<sup>154</sup> The debtor shall be responsible to the creditor for liability for any breach if the third party fails to perform or improperly performs the obligation.<sup>155</sup>

Related to all these performance provisions, the Uniform Contract Law further contains some provisions on protection of creditors. According to these provisions, a creditor may refuse early performance unless early performance will not affect the realization of the creditor's contractual rights.<sup>156</sup> Even if early performance is permitted, the debtor shall bear all the additional costs as a result of early performance.<sup>157</sup> Similarly, a creditor may refuse partial performance unless partial performance does

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145. *See id.*

146. *See id.* art. 56.

147. *See id.*

148. *See Contract Law* art. 57.

149. *See id.* art. 58.

150. *See id.*

151. *See id.*

152. *See id.* art. 64.

153. *See id.*

154. *See id.*

155. *See id.*

156. *See id.* art. 71.

157. *See id.*

not affect the realization of the creditor's rights.<sup>158</sup> Where partial performance is permitted, the debtor shall pay any additional costs incurred by the creditors.<sup>159</sup>

If a debtor is recklessly slow in realizing his rights, causing harm to the contractual creditor, that creditor may have the right of subrogation to realize the debtor's rights in his own name unless those rights exclusively belong to the debtor.<sup>160</sup> The scope of the right of subrogation shall not exceed the creditor's rights.<sup>161</sup> Any costs incurred for the exercise of the right of subrogation shall be borne by the debtor.<sup>162</sup> Similarly, if a debtor abandons his rights or freely gives away his properties without receiving any payment, causing harm to the creditor, the creditor may request the court to declare the debtor's act void.<sup>163</sup> This also applies to a case where the debtor transfers his property at an unreasonably low price, causing harm to the creditor. A condition in this case is that the transferee is also at fault.<sup>164</sup> The scope of the right to cancel the debtor's act is limited to the creditor's right.<sup>165</sup> That right must be exercised within one year from the date the creditor knows of the improper act or five years from the date of the improper act.<sup>166</sup> Any costs incurred for the exercise of the right is borne by the debtor.<sup>167</sup>

#### IV. PROBLEMS TO BE RESOLVED

##### A. RELATION WITH THE GPCL

As this Contract Law is intended to replace the existing three major contract laws, the substantive provisions of the Contract Law apply to the current domestic economic contracts and foreign economic contracts. The ambitious drafters have intended that this Contract Law form part of a prospective Civil Code. However, the drafters still have not planned to amend the GPCL to make the Contract Law compatible with the GPCL. As a result, there are possible conflicts between the GPCL and the Contract Law. For instance, there is a provision in the Contract Law that says that if this law is inconsistent with other laws, the provisions in other laws prevail.<sup>168</sup> This provision is problem-

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158. *See id.* art. 72.

159. *See id.*

160. *See id.* art. 73.

161. *See id.*

162. *See id.*

163. *See id.* art. 74.

164. *See id.*

165. *See id.*

166. *See id.* art. 75.

167. *See id.* art. 74.

168. *See id.* art. 10.

atic. If any conflict or inconsistency between the GPCL and the Contract Law excludes the latter law, the benefit of the improvements made in the Contract Law will not be available to contractual transactions after October 1, 1999. In addition, this provision also operates against a basic principle of Chinese jurisprudence that a subsequent law shall prevail if any previous law contradicts the subsequent law. If other laws mean other special laws as compared with the general Contract Law, this provision is meaningless. Under Chinese jurisprudence, the relationship between general law and special law is well established. In case there is any conflict or inconsistency between a general law and a special law, the special law prevails. The general law on a particular point applies if the special law is silent. For instance, if a conflict exists on a particular legal point between the Contract Law and the Law on Chinese-foreign Equity Joint Ventures,<sup>169</sup> the law on Equity Joint Ventures prevails as a special law.

#### B. NATURE OF DAMAGES

The remedy of damages is an important method to assist an innocent party. According to the GPCL, the liability for breach of contract shall be equal to the loss suffered by the other party. As the GPCL is very brief, it does not specify the extent of the actual loss.<sup>170</sup> While the innocent party is entitled to compensation, he is also required to take prompt measures to prevent an increase in loss.<sup>171</sup> If measures are not adopted to mitigate the loss, the injured party does not have the right to demand compensation for the resulting increase in damages. Parties to a contract have freedom to specify in a contract that one shall pay the other party a certain amount of damages.<sup>172</sup> The parties may also specify in the contract the method of assessing the amount of compensation for any loss resulting from a breach of contract.<sup>173</sup> Liability for breach of contract may be partly or entirely exempted if force majeure or a change of circumstance causes non-performance.

Under the FECL, damages are a major remedy for breach of contract. The FECL provides that in case of breach, the innocent party is entitled to claim damages or demand other reasonable measures.<sup>174</sup> Damages include liquidated damages and compen-

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169. This Law was adopted at the Seventh Session of the Fifth National People's Congress on July 1, 1979.

170. This is a defect that was corrected first in the FECL and then in the Uniform Contract Law. See FECL art. 19; *Contract Law* art. 113.

171. See GPCL art. 114.

172. See *id.* art. 112.

173. See *id.*

174. See FECL art. 18.

satory damages. Liquidated damages are another important remedy particularly in the contract law regime for domestic economic contracts. Liquidated damages mean that a breaching party at fault shall pay a certain amount of money to the innocent party as fixed by the law or specified in the contract. Liquidated damages have three characteristics. First, liquidated damages are prefixed either by law or by the parties in the contract. Second, payment of liquidated damages is conditioned upon one party's breach and fault. Under Chinese law in the past, whether harm is caused to the other party is irrelevant. Third, liquidated damages have the nature of compensating the innocent party and of penalizing the breaching party. When the breach does not result in any actual loss to the innocent party, he is still entitled to claim liquidated damages from the breaching party. In this case, liquidated damages are punitive. When the breach causes actual loss that is greater than the liquidated damages, liquidated damages have the effect of compensating the injured party. Where the loss caused by the breach is smaller than the liquidated damages, it is both punitive and compensatory.

Liquidated damages may be regulated by law or agreed upon by the parties. Administrative regulations may fix the range of liquidated damages. In that case, the parties have to adopt an amount within the regulated range. An example can be found in the Regulation on Contracts for the Sale of Industrial and Mineral Products. Article 35 of that Regulation provides that if the supplier fails to deliver the goods, he shall pay liquidated damages to the other party. For general products, the amount of liquidated damages shall be between one and five percent while for specialized products, the amount of liquidated damages shall be between ten and thirty percent. The parties may negotiate the amount within that legally regulated range. Where the law or regulations do not have specific provisions on the calculation of liquidated damages, or where the regulations on contracts have such provisions but permit the parties to agree otherwise, the parties to an economic contract may specify the amount of liquidated damages when forming the contract.

Liquidated damages in domestic economic contracts are different from liquidated damages in foreign economic contracts in two fundamental ways. First, only the parties agree upon liquidated damages in foreign economic contracts. The parties may agree in a contract that if one party breaches the contract, that party shall pay a certain amount of damages to the other party. The parties may also agree upon a formula for calculating the damages resulting from such a breach.<sup>175</sup> The formulas are not

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175. *See id.* art. 20.

fixed by laws or regulations. Second, since liquidated damages in foreign economic contracts are compensatory by nature, a party may request a court or an arbitration body to reduce or increase the liquidated damages if the contractually agreed amount varies substantially from what is necessary to compensate for the losses resulting from the breach.<sup>176</sup>

When the liquidated damages are inadequate to compensate for the actual loss suffered by the injured party or where there are no liquidated damages, compensatory damages have to be paid.<sup>177</sup> Compensatory damages are determined after a breach occurs. They are not punitive in nature. Normally, compensatory damages cover loss to or destruction of property, expenditures incurred, and expectation loss from the contract.

Against this harsh rule, there are some exceptions. The first exception is that the loss to be compensated must be foreseeable at the time the contract is entered into. Such a rule is clearly specified in the FECL.<sup>178</sup> By virtue of this article, the amount of compensation shall not be more than the amount of losses that the party in breach should have foreseen at the time when the contract is made.<sup>179</sup> This provision reduces the harshness created by Article 18 of the FECL. The FECL Answers clarify that damages for breach of contract include destruction, reduction or loss of property, expenses incurred in reducing or preventing such losses, and interest that could have been earned had the contract been performed. As for international sale of goods contracts, the interest that could have been earned includes loss of profits.<sup>180</sup> Although the ECL is silent on this point, academic writing supports the position that the loss of profits should be included.<sup>181</sup> Moreover, the distinction between domestic economic contracts and foreign economic contracts is not very important after China moved to a market-oriented economy in 1993. Courts are more likely to treat these contracts similarly on this point. The second exception is that the injured party must mitigate any losses.<sup>182</sup> The non-breaching party has a duty to take proper measures in time to prevent any possible increase in loss. If that party fails to do so, he has no right to claim compensation for the increased portion of the loss.<sup>183</sup> The third exception is limited liability for

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176. *See id.*

177. *See* ECL art. 31. The FECL contains a similar provision stating compensatory damages can be claimed by the innocent party if other remedies are not sufficient to compensate the losses. *See* FECL art. 18.

178. *See* FECL art. 19.

179. *See id.* art. 19.

180. *See FECL Answers* art. 6(1).

181. *See* ZHONGGUO JINGJI HETONG FAXUE 120-21 (Wu Hong ed. 1993).

182. *See* GPCL art. 114.

183. *See* FECL art. 22.

certain types of contracts. For instance, in carriage of goods contracts and supply of electricity contracts, the liability of the carrier and supplier is limited to a certain extent.

The Contract Law still retains the remedy of liquidated damages set forth in the contract law before 1999. Under the Contract Law, the parties may agree in a contract that if one party breaches, he shall pay liquidated damages to the other party. The parties may also agree upon a method for calculating the damages resulting from such a breach.<sup>184</sup>

Where the parties do not specify liquidated damages or the method for calculating the damages, the liability of a party to pay compensation for breach of a contract shall be equal to the loss suffered by the other party as a consequence of the breach,<sup>185</sup> including any expected benefits from performance.<sup>186</sup> However, such compensation may not exceed the loss that the parties responsible for the breach ought to have foreseen at the time of the conclusion of the contract as a possible consequence of the breach.<sup>187</sup>

### C. GOVERNMENTAL INTERVENTION

Although the Uniform Contract Law considerably has enlarged the scope of freedom of contract, it still retains much room for governmental intervention.

#### 1. *Contents of Contracts*

The Chinese contract law usually controls the content of contracts by requiring the parties to set forth certain terms in their contracts. The content of a contract defines the contractual parties' rights and obligations. The content of a contract is expressed through major and minor clauses. In addition, mandatory legal provisions in various laws and regulations, together with judicial interpretation and customs, may also become part of the content of a contract.

Major clauses are the necessary and sufficient conditions for the formation of contracts. Lack of major terms makes it impossible for the formation of contracts. On the other hand, a contract comes into existence if major clauses are agreed upon even if some minor clauses are not clear or missing. Three factors are generally used to evaluate whether a clause is a major one. In the first place, clauses mandated by laws or regulations are normally major clauses in a contract. Secondly, if the nature of a

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184. See *Contract Law* art. 114.

185. See *id.* art. 113.

186. See *id.*

187. See *id.*

contract requires certain clauses to achieve the objectives of that type of contract, these clauses are major clauses. Thirdly, clauses specifically insisted upon by one of the parties are major clauses. They are essential for the formation of contract.

Non-major clauses are minor clauses. While they generally may not affect the formation of contracts, they are still important. They clarify the rights and obligations of the parties and facilitate the implementation and enforcement of contracts. Generally speaking, major clauses include the subject matter of a contract, quality and quantity of the subject matter, price or payment of the contract, place and method of delivery, performance, and liability for breach of contract. Lack of these clauses may affect the formation of a contract.

Under the FECL, a foreign economic contract shall contain the following clauses: name, nationality, principal place of business or domicile of the parties; date and place of contracting; type of contract; technical requirements including quality, standard, specification and quantity of the subject matter; time, place and method of performance; price, currency and method of payment; liabilities for breach of contract; and dispute resolution.<sup>188</sup> In addition to these major clauses, there also exist some other clauses. The parties may specify these clauses. While these clauses may be missing in some contracts, the existence of these clauses does not mean that they are not important. Like major clauses, they also clarify the rights and obligations of the contractual parties. Similar to the provision of the FECL, the Uniform Contract Law also requires that a contract generally include the following clauses: name, domicile of the parties; subject matter; quantity; quality; price; time, place and method of performance; liabilities for breach of contract and dispute resolution.<sup>189</sup>

## 2. *State Plan*

The Uniform Contract Law retains some provisions involving the features of a planned economy. For instance, the state may still impose mandatory plans or order quotas on legal persons or other economic organizations.<sup>190</sup> In such a case, legal persons or other economic organizations must draft the contract in accordance with the relevant law or regulations that prescribe their rights and obligations.<sup>191</sup> Where the contract is not clear

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188. See FECL art. 12.

189. See *Contract Law* art. 12.

190. See *id.* art. 38.

191. See *id.*

about the quality or the price, the state standard or the government fixed price should apply.<sup>192</sup>

### 3. "Subject To" Clauses

Apart from the explicit provisions allowing for governmental intervention, the Contract Law has provided much potential room for governmental intervention by using many "subject to" clauses. In other words, although the Contract Law has enlarged the scope of freedom of contract, such provisions relating to freedom of contract may be subject to further legislative or administrative requirements. For instance, under the Contract law, a contract may be oral, in writing or in other forms.<sup>193</sup> However, if the law or administrative regulations require a written contract, the contract must be in writing.<sup>194</sup> Also, a contract generally becomes effective when it is formed.<sup>195</sup> However, the law or administrative regulations may require that a contract only becomes effective when it is approved or registered.<sup>196</sup> The parties to the contract may alter the contract by mutual agreement.<sup>197</sup> But the law or administrative regulations may require such variation to be approved or registered.<sup>198</sup> The parties to a foreign-related contract may choose the applicable law governing the contract.<sup>199</sup> This freedom is also subject to other provisions in the law.<sup>200</sup> Other articles containing "subject to" clauses include Articles 129, 132, 133 137,142 and 150. All these "subject to" clauses have provided much potential for governmental intervention. Thus, if the government is ready to intervene, all the government needs to do is simply enact administrative regulations that restrain freedom of contract.

### 4. Privity of Contract

The Contract Law has in principle recognized the doctrine of privity of contract,<sup>201</sup> regarding this doctrine as protecting the

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192. *See id.* art. 62 (1) (2), 63.

193. *See id.* art. 10.

194. *See id.*

195. *See id.* art. 44.

196. *See id.*

197. *See id.* art. 77.

198. *See id.*

199. *See id.* art. 126.

200. *See id.*

201. Under this common law doctrine, no one may be entitled to or bound by the terms of a contract to which he is not an original party. For a detailed discussion of this doctrine, see M. P. FURMSTON, CHESHIRE, FIFOOT, & FURMSTON'S LAW OF CONTRACT 450-66 (12th ed. 1991). For case reference, see *Price v Easton* 4 B & Ad 433 (1833); *Tweddle v Atkinson* 1 B & S 393 (1861).

legal interests of the contractual parties.<sup>202</sup> This doctrine does not apply where the interests and rights of the state, the collective (*jiti*) or the third party have been damaged by the contract into which the contractual parties have entered. Under this circumstance, not only the contract shall be declared void,<sup>203</sup> but the property gained from the contract should be recovered and turned over to the state or paid back to the collective or the third party.<sup>204</sup> The problem is in what capacity the state, the collective or the third party recovers or gets back the property the contractual parties have gained from the contract. It is quite obvious that the state, the collective or the third party is not a party to the contract and thus none of them is entitled to any rights under the contract. The Uniform Contract Law protects only the legal interests of the contractual parties as expressed in its legislative purposes.<sup>205</sup> As the legal status of the state, the collective and the third party is unclear, this poses another question as to how they will recover their interests damaged by the invalid contract. The Uniform Contract Law entitles administrative authorities to supervise all illegal activities by voiding contracts that have damaged the interests of the state and the public.<sup>206</sup> This provision appears to suggest that administrative authorities shall determine whether a contract has damaged the interests of the state, the collective or the third party. This entitlement has not only provided much potential for governmental intervention but is unfair to the contractual parties.

#### D. SPECIFIC PERFORMANCE

In contrast with contract regimes in other countries, particularly those in common law jurisdictions, the Chinese contract law regards specific performance as the major remedy for breach of contract. Specific performance requires a contractual party to honor the promises made in the contract. The GPCL provides that when one party fails to perform his contractual duty, or his performance is not in accordance with the agreed terms, the

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202. See *Contract Law* art. 1.

203. See *id.* art. 52 (1) (2). Under these provisions of the Uniform Contract Law, contracts concluded under threat of blackmail by one party, and damaging the interests of the state, or concluded by both parties who collude with the malicious intent to damage the interests and rights of the state, the collective, or a third party, shall be declared void.

204. See *id.* art. 59. Under this article of the Uniform Contract Law, in cases where both parties collude with the malicious intent to conclude a contract which has damaged the interests and rights of the state, the collective or a third party, the property thus gained shall be recovered and turned over to the state or paid back to the collective or third party.

205. See *Contract Law* art. 1.

206. See *id.* art. 127.

other party has a right to demand performance or take measures to correct the defective performance.<sup>207</sup> As compared with economic contracts the reasons for specific performance in civil contracts is less strong except for the purchase of houses or unique goods. For economic contracts, the remedy of specific performance is used to strengthen State planning of economic activities. This was particularly true before China moved to a market-oriented economy in 1993. The legal provision on specific performance provides that if the injured party required continuation of the contract, the breaching party shall continue to perform his obligations.<sup>208</sup> However, specific performance is not specifically provided in the FECL. Lack of such a legal provision implies that the remedy of specific performance is much less important in foreign economic contracts than in domestic economic contracts. The reason is that China's economic planning cannot be extended outside its jurisdiction. This does not mean, however, that the remedy is not available since this remedy may be implied from the phrase "other reasonable remedies" in Article 18 of the FECL.

The Uniform Contract Law retains the remedy of specific performance. The current rationale for the specific performance remedy is to preserve any unique value in the subject matter of the contract obtained through bargain by the buyer. Thus, a party may apply for specific performance if the other party fails to perform a non-pecuniary obligation.<sup>209</sup> Although the scope of specific performance in the Uniform Contract Law is narrow compared with that in the ECL,<sup>210</sup> its application should be further restricted to keep pace with international practice. Under the CISG, in international sale of goods, the primary remedy for breach of contract is damages rather than specific performance.<sup>211</sup>

## V. CONCLUSION

Although the Uniform Contract Law is far from satisfactory, it has brought about considerable changes to China's contract regime. This regime has moved from administrative authority towards a rule of law. The underlying force for the change is China's economic reform program. After the completion of

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207. See GPCL art. 111.

208. See ECL art. 31.

209. See *Contract Law* art. 110.

210. Three exceptions exist. First, when performance is impossible in law or in fact; second, when it is inappropriate to specifically perform the contract or too costly to specifically perform the contract; third, when the creditor does not apply for specific performance within a reasonable time. See *Contract Law* art. 110.

211. See ZHONG & WILLIAMS, *supra* note 4, at 169.

China's nationalization and collectivization at the end of the 1950s, contract law in China became an instrument to facilitate and strengthen the rigid planned economy. Contract formation and methods of dispute resolution were quite administratively oriented. Although certain contracts between collective enterprises were not strictly planned, administrative bodies were heavily involved in the processes of approval, monitoring, and dispute resolution. Contracts between individuals were normally not related to production and were informally dealt with. The economic reform program that started in 1978 allowed the entry of foreign investors and domestic individuals in the allocation of productive resources. The permission of the private sector in the economy made it difficult to rely on the traditional administrative means to deal with contracts. The change from a planned economy to a commodity economy in 1984 and finally to a market-oriented economy in 1993 greatly shaped the development of Chinese contract law.

The experience of the past and learning from the West made improvements in contract law technically easier. The most recent Uniform Contract Law has reflected these forces. The Uniform Contract Law significantly enlarged the autonomy of contractual parties. Administrative means of contractual regulation gradually have been replaced by contract regulation based on a rule of law. The Uniform Contract Law has also provided relatively detailed rules which help to save negotiation and enforcement costs. The Uniform Contract Law has also moved to a very large extent from a mandatory model to an enabling model of contract law. If past economic reform has changed China's focus from planning to individual exchange, this Uniform Contract Law has provided the legal means for liberalizing the Chinese economy.