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## Convergence, Culture and Contract Law in China

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## Article

# Convergence, Culture and Contract Law in China

John H. Matheson\*

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## INTRODUCTION

At the height of the Industrial Revolution, Britain was called "the Workshop of the World."<sup>1</sup> That title surely belongs to the People's Republic of China (PRC)<sup>2</sup> today. For example, China already is the world's fastest-growing large economy and the second largest holder of foreign-exchange reserves.<sup>3</sup> Furthermore, China is now the world's largest producer of coal, steel, and cement.<sup>4</sup> It is the second largest consumer of energy and the third largest importer of oil.<sup>5</sup> China's exports to the United States have grown by 1600% over the past fifteen years, and U.S. exports to China have grown by 415%.<sup>6</sup> Lastly, China is a huge manufacturer and exporter of consumer goods, producing two thirds of the world's copiers, microwave ovens, DVD players, shoes, and toys.<sup>7</sup>

Aside from housing the world's largest economic unit,<sup>8</sup> China's incredible growth, both in population and consumption,

1. Steven Kreise, *Lecture 17: The Origin of the Industrial Revolution in England*, THE HISTORY GUIDE, <http://www.historyguide.org/intellect/lecture17a.html> (last revised May 13, 2004):

There is no denying the fact that the Industrial Revolution began in England sometime after the middle of the 18th century. England was the "First Industrial Nation." As one economic historian commented in the 1960s, it was England which first executed "the takeoff into self-sustained growth." And by 1850, England had become an economic titan. Its goal was to supply two-thirds of the globe with cotton spun, dyed, and woven in the industrial centers of northern England. England proudly proclaimed itself to be the "Workshop of the World," a position that country held until the end of the 19th century when Germany, Japan and United States overtook it.

*Id.*

2. Throughout this paper "PRC" or "China" refers to the People's Republic of China, which for the purposes of this paper does not include Hong Kong, Macau, or Taiwan. The translations of Chinese laws and words are taken from various secondary sources. In general, the *pinyin* system of Romanization is used for Chinese words, except where a common spelling exists for the word under another system.

3. Fareed Zakaria, *Does the Future Belong to China?*, NEWSWEEK, May 9, 2005, at 28. China "has the world's largest army (2.5 million men) and the fourth largest defense budget, which is rising by more than 10 percent annually." *Id.* at 29.

4. *Id.* at 28.

5. *Id.*

6. *Id.*

7. *Id.*

8. Patricia Pattison & Daniel Herron, *The Mountains Are High and the Emperor is Far Away: Sanctity of Contract Law in China*, 40 AM. BUS. L.J. 459, 460 (2003). China's economy is not only larger than that of any other single nation, but it also tops the list when including trading blocs such as NAFTA and the EU. *Id.*

make it far and away the most emergent market in the world. Unlike other developing countries, China has virtually unlimited capital to invest in technology and is now the highest investor in research and development in the developing world.<sup>9</sup> The extent of its domestic research and development facilities, the size of its home market, and the accessibility to other markets in Asia make China a logical place for investment by U.S. businesses.<sup>10</sup>

Of course, the great majority of China, especially the less populated inland regions, remains underdeveloped by Western standards. This presents a great opportunity for Western developers, financiers, and other foreign investors.<sup>11</sup> Power, telecommunication, and other projects of public utility must reflect the grand scale of China's population in order to meet its need.<sup>12</sup> Private market investment will also be increasingly attractive as China's consumer market continues to grow. Passive investment in China is easy enough; the country's financial infrastructure is more than capable of repatriating profits. But significant investors, especially those financing public use type projects, will want something more than speculation. Venturing directly into China is not for the faint of heart; it requires the courage, tenacity, and creativity of an explorer in a new land.<sup>13</sup>

China's high gross domestic production combined with an

9. Mikhaelle Schiappacasee, *Intellectual Property Rights in China: Technology Transfers and Economic Development*, 2 BUFF. INTELL. PROP. L.J. 164, 183 (2004).

10. *Id.*

11. The most attractive project finance structures are unavailable to Western firms, as China still frowns on direct foreign ownership of any company, much less those with significant effects on infrastructure such as project finance. However, providing financing to Chinese construction firms, for example, has never been banned; and while the structure is losing its former popularity, the joint venture still provides some opportunity for Western nations to become directly involved in construction and perhaps ownership. See Michele Lee, *Franchising in China: Legal Challenges When First Entering the Chinese Market*, 19 AM. U. INT'L L. REV. 949, 959-60 (2004).

12. The Three Gorges Dam powerfully reflects this need. The dam will be 185 meters high, nearly two kilometers wide, hold forty billion cubic meters of water, and require U.S. \$25 billion in capital according to government predictions. It is four times as wide as the Hoover Dam. See generally Andrea Wong, *China's Energy Policy and Competing International Environmental Pressures*, 2000 COLO. J. INT'L ENVTL. L. & POL'Y Y.B. 271, 276-77 (2000) (describing the massive Three Gorges Dam, but indicating that the Dam will be responsible for severe environmental damage).

13. U.S. direct investment in China totals only U.S. \$48 billion, compared to the size of the Chinese economy (U.S. \$1.65 trillion). BUREAU OF EAST ASIAN AND PACIFIC AFFAIRS, U.S. DEPARTMENT OF STATE, BACKGROUND NOTE: CHINA (Mar. 5, 2005), available at <http://www.state.gov/r/pa/ei/bgn/18902.htm>.

extensive consumer market has led many multinational corporations to consider doing business in China. While there are a number of factors that lead corporations to enter new markets, one of the factors that should be examined is the legal system and legal regimes that will affect the transaction itself. As the PRC's legal system is based in the civil law tradition, its sources of law, the role of judicial decision-making, and the role of the statute or Code differ a great deal from some other systems, especially those built on a common law tradition, such as the United States and Great Britain.

In 1999, the PRC enacted the Uniform Contract Law (UCL).<sup>14</sup> The UCL was enacted for the purpose of "protecting the legitimate rights and interests of the parties to contracts, maintaining the socio-economic order and promoting the socialist modernization."<sup>15</sup> This promulgation of the UCL was especially important to China because of China's then desire to join the World Trade Organization (WTO).<sup>16</sup>

This article discusses selected aspects of Chinese contract law and compares Chinese contract law to related concepts in the U.S. legal system. As recognized by the author and discussed further at the end of the article, any comparative analysis of the *law as written* is fraught with potential superficiality and misperception.<sup>17</sup> Such problems notwithstanding, this is not a study of the *law as applied* because there are few reported cases that have been decided under the new law. Still, several

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14. Uniform Contract Law (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), translated in CHINESE CIVIL LAW FORUM CCLAW.NET (find at <http://www.cclaw.net/download/contractlawprc.asp>) (P.R.C.) [hereinafter UCL]. The UCL applies to all contracts formed on or after October 1, 1999, as well as to certain provisions of contracts formed before that date and disputes arising out of the performance of contracts formed before that date where performance began or continued after October 1, 1999. See The Supreme People's Court's Interpretations of Certain Issues Concerning the Application of the Contract Law, adopted at the 109th Sess. of the Adjudication Comm. of the Sup. People's Ct., Dec. 1, 1999, art. I, cl.1-2, translated in ISINOLAW (find at <http://www.isinolaw.com>) (P.R.C.). See generally Pitman B. Potter, *Contract Law*, in DOING BUSINESS IN CHINA I-6.2.1, 6.2.02 n.49 (Freshfields Bruckhaus Deringer's China Business Group ed., 2004) (discussing the drafting process of the UCL); Peter Howard Corne, *Creation and Application of Law in the PRC*, 50 AM. BUS. L.J. 369 (2002) (discussing characteristics of China's legal system and law making process).

15. UCL, art. 1 (P.R.C.).

16. See Feng Chen, *The New Era of Chinese Contract Law: History, Development and a Comparative Analysis*, 27 BROOK. J. INT'L L. 153, 153-54 (2001); Patti-son & Herron, *supra* note 8, at 459.

17. See generally NEIL J. DIAMANT, STANLEY B. LUBMAN & KEVIN J. O'BRIEN, *ENGAGING THE LAW IN CHINA: STATE, SOCIETY, AND POSSIBILITIES FOR JUSTICE* (2004); ESIN ORUCU, *THE ENIGMA OF COMPARATIVE LAW* (2004).

cases decided both before and after the adoption of the UCL are used for illustration. Also, the *law as written* may not be the *law as observed* in its daily application to commerce and consumers. Custom and culture often play an overriding role in the actual observance and enforcement of the law.<sup>18</sup>

Despite these limitations, important insights may be gleaned from a comparative contract law perspective. Indeed, knowledge of the law as written and its variation from the common law “norm” is an essential starting point for Western businesses in contracting with and investing in China and Chinese businesses. Part I of this article briefly discusses the evolution of Chinese contract law and its apparent convergence in many respects with U.S. common law and international conventions. Part II addresses specific, selected aspects of comparison between Chinese and U.S. contract law. Part III identifies some limitations of the analysis based on cultural and developmental distinctions between China and Western societies and contract law systems.

## I. THE DEVELOPMENT AND CONVERGENCE OF CHINESE CONTRACT LAW

### A. PRE-1999 CHINESE CONTRACT LAW

Prior to the economic reforms in 1978, contract law effectively did not exist in China.<sup>19</sup> From 1919 to 1930 the Chinese Nationalist government instituted European codes.<sup>20</sup> But in 1949, the communist government came to power and repealed these codes.<sup>21</sup> During the ensuing fifty years, there were four stages in the evolution of Chinese contract law.

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18. China's history, philosophy, and culture have led to a business environment in which the common good and personal relationships may be valued over the rule of law. Laws may exist but may not be enforced. For example, despite numerous laws on the record in compliance with international treaties and standards intended to protect the intellectual property rights of both Chinese and foreign business people, China has one of the highest intellectual property infringement rates in the world. In 2004, it was estimated that every year businesses in the United States lose as much as two billion dollars to piracy in China. See Schiappacasee, *supra* note 9, at 164–65.

19. Feng Chen, *supra* note 16, at 155.

20. WEI LUO, *THE CONTRACT LAW OF THE PEOPLE'S REPUBLIC OF CHINA* vii (1999) (noting that these codes are still used today in Taiwan).

21. *Id.*



### 1. *State-Planned Economic Contract System (1950–1956)*

The first contract procedures and the corresponding administrative laws were formulated to recover economic losses from military conflicts and to nationalize private enterprises.<sup>22</sup>

### 2. *The Loss of and Subsequent Restoration of the Contract System (1961–1965)*

During the Great Leap Forward (1958–1961), the government eliminated private ownership and free markets.<sup>23</sup> This change generated few incentives for contracting parties to fulfill contractual obligations and prevented the State-Planned economic contract system from being fully implemented.<sup>24</sup> In 1961 the government retreated and returned some farmlands to the peasants.<sup>25</sup> It also used contract regulations to rebuild the economy.<sup>26</sup> However, further development of the contract system was interrupted by the Cultural Revolution.<sup>27</sup>

### 3. *Reformed State-Planned Contract System (1978–1992)*

Starting in 1978 China began opening up to the outside world.<sup>28</sup> In 1978 Chairman Deng Xiaoping sought to establish a modern legal system<sup>29</sup> as China changed into a more market-oriented economy from its planned economy.<sup>30</sup> In 1981 the National People's Congress (NPC), the highest law making body in the PRC,<sup>31</sup> passed its first major contract law, the Economic Contract Law (ECL).<sup>32</sup> The ECL was a significant move towards

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22. *Id.* at 1.

23. *Id.* at 2–3 (noting that during the Great Leap Forward the Chinese government placed peasants under a single local administrator in order to mobilize the economy toward unrealistic goals).

24. *Id.* at 3.

25. *Id.* at 3.

26. *Id.* Administrative regulations were passed in order to restore the state-planned economic contract system. Further regulations directed every sector of the national economy to strictly enforce economic contracts. *Id.* at 3–4. Local People's Banks and Construction Banks were responsible for enforcing the decisions given by "economic committees" who were the arbitrators in the event of a dispute. *Id.* at 4.

27. *Id.*

28. *Id.* at 8.

29. *Id.* at 4.

30. WEI LUO, *supra* note 20, at 8.

31. Feng Chen, *supra* note 16, at 154.

32. Economic Contract Law (promulgated by the Nat'l People's Cong., Dec. 13, 1981, effective July 1, 1982), *translated in* ISINOLAW (find at

a more decentralized, market-oriented, and incentive-based economy.<sup>33</sup> The ECL, however, only applied to Chinese domestic contracts and not to those involving foreign persons or entities.<sup>34</sup> Moreover, its classification as economic law as opposed to civil law meant that its role was to implement state economic policies.<sup>35</sup>

As the needs for contract law grew, the NPC enacted the Foreign Economic Contract Law (FECL)<sup>36</sup> in 1985 and the Standing Committee of the NPC (Standing Committee) enacted the Technology Contract Law (TCL)<sup>37</sup> in 1987.<sup>38</sup> These three laws together with various administrative regulations (collectively, the Pre-1999 Contract Laws) formed the basis for contract law during the two decades prior to the UCL's promulgation. However, these laws and regulations were filled with contradictions, redundancies and other problems.<sup>39</sup> In 1986, in a further step to create a comprehensive legal system, China enacted the General Principles of the Civil Law (GPCL), which also had a significant impact on the basic principles of contract law.<sup>40</sup>

#### 4. *Leading Up to the Uniform Contract Law (1993–1999)*

In 1993, China made a significant amendment to the ECL which decreased the government's power to intervene in contract formation and performance.<sup>41</sup> But the amendment did not

<http://www.isinolaw.com>) (P.R.C.) [hereinafter ECL].

33. Feng Chen, *supra* note 16, at 155.

34. *Id.* at 160.

35. See Wang Liming & Xu Chuanxi, *Fundamental Principles of China's Contract Law*, 13 COLUM. J. ASIAN L. 1, 3 (1999).

36. Law on Economic Contracts Involving Foreign Interest (adopted by Standing Comm. Nat'l People's Cong., Mar. 21, 1985, effective July 1, 1985) (P.R.C.) [hereinafter FECL].

37. Law on Technology Contracts (promulgated by the Standing Comm. Nat'l People's Cong., June 23, 1987, effective June 23, 1987), translated in ISINOLAW (find at <http://www.isinolaw.com>) (P.R.C.) [hereinafter TCL].

38. Feng Chen, *supra* note 16, at 155–57.

39. See Wang Liming & Xu Chuanxi, *supra* note 35, at 3–9 (1999) (discussing the problems with the Soviet derived notion of an "economic" contract, as well as the contradictions, inconsistencies and lack of basic contract rules in the Pre-1999 Contract Laws).

40. Feng Chen, *supra* note 16, at 156.

41. WEI, *supra* note 20, at 8–9. The amendment reduced the requirement that called for contracting parties to observe state economic planning and it decreased the extent to which administrative agencies may determine the validity of contracts. *Id.* The amendment authorized courts and arbitrators to determine the validity of contracts. *Id.*

resolve many of the system's problems, such as inconsistency and redundancy.<sup>42</sup> These problems and China's impending admission to the WTO led the Chinese government to enact a uniform contract law.<sup>43</sup> The government then began working on the UCL, and even released a public draft in order to receive feedback from the people.<sup>44</sup> Taking into account six major revisions, the NPC passed the final draft of the UCL in 1999.<sup>45</sup>

## B. UNIFORM CONTRACT LAW

The UCL came into effect on October 1, 1999.<sup>46</sup> As mentioned, enactment of the UCL was part of China's continued efforts to join the WTO.<sup>47</sup> China simultaneously repealed the ECL, the FECL, and the TCL.<sup>48</sup> Accordingly, current PRC contract law is governed by the UCL and GPCL. In drafting the new regulation, Chinese legislators referred extensively to the Principles of International Commercial Contracts drafted by the International Institute for the Unification of Private Law (UNIDROIT Principles),<sup>49</sup> the United Nations Convention for the International Sale of Goods (CISG),<sup>50</sup> and other foreign legal standards.<sup>51</sup>

42. *Id.* at 9.

43. Feng Chen, *supra* note 16, at 154; Pattison & Herron, *supra* note 8, at 459.

44. WEI LUO, *supra* note 20, at 9.

45. *Id.* at 10. The six major revisions included: 1) reducing the scope of law to exclude agreements relating to marriage and adoption, which would be regulated by other, more relevant laws; 2) placing greater emphasis on full performance (for example, UCL art. 60 reads: "Parties to a contract shall fully fulfill their obligations according to the agreement."); 3) eliminating one's ability to forego his or her obligation due to hardships; 4) adding quality warranties in an effort to exert stricter control over construction projects; 5) strengthening the rights of lessees; and 6) requiring that technological development contracts and contracts that deal with the transfer of technology be in writing. *Id.*

46. BING LING, *CONTRACT LAW IN CHINA* 16 (2002); see also WEI LUO, *supra* note 20, at viii (noting that the Contract Law repealed the Economic Contract Law, the Foreign Economic Contract Law, and the Technology Contract Law).

47. Feng Chen, *supra* note 16, at 154.

48. See UCL, art. 428 (P.R.C.).

49. See BING LING, *supra* note 46, at 37-38 (citing the UNIDROIT Principles as one source examined in the drafting of Chinese Contract Law). Compare UCL and INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW (UNIDROIT), *PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS* (1994), reprinted in 34 I.L.M. 1067 [hereinafter UNIDROIT PRINCIPLES].

50. See BING LING, *supra* note 46, at 37-38 (citing CISG as one source examined in drafting the UCL). Compare UCL and Convention on Contracts for the International Sale of Goods, art. 1(a), Apr. 11, 1980, U.N. Doc. A/CONF.97/18 [hereinafter CISG].

51. See BING LING, *supra* note 46, at 37-38 (discussing the various foreign laws

The UCL maintains the development of China's socialist market economy<sup>52</sup> and builds upon the Pre-1999 Contract Laws.<sup>53</sup> The new contract law is based on China's actual conditions, but also draws on the experiences of other countries.<sup>54</sup> The UCL treats domestic and foreign contracts similarly.<sup>55</sup> It is more specific and comprehensive than the previous contract laws.<sup>56</sup> The UCL has 129 articles dealing with fundamental contract issues (General Principles) and 299 articles dealing with fifteen types of contracts such as sale, gift, and construction contracts (Specific Provisions).<sup>57</sup>

Given that the Chinese economy had been integrated with the world economy for twenty years, prior to the passing of the UCL, Chinese legislators sought to incorporate into the UCL certain general principles of international contract law.<sup>58</sup> The UCL also acknowledges that contracts can be validly formed using modern means of communication, such as electronic mail (e-mail) and electronic digital interchanges (EDI).<sup>59</sup> Scholars be-

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examined in the drafting of the UCL); Feng Chen, *supra* note 16, at 153–54 (“In order to keep pace with international standards, China has absorbed many matured legal doctrines from both civil and Anglo-American systems.”); James C. Hitchingham, *Stepping Up to the Needs of the International Market Place: An Analysis of the 1999 “Uniform” Contract Law of the People’s Republic of China*, 1 ASIAN-PAC. L. & POL’Y J. 8: 4 (2000), <http://www.hawaii.edu/aplpj/pdfs/08-jim.pdf> (noting that, when drafted, the UCL “borrowed many foreign legal standards that Chinese jurisprudence [had] not yet defined”); Zhang Yuqing & Huang Danhan, *The New Contract Law in the People’s Republic of China and the UNIDROIT Principles of International Commercial Contracts: A Brief Comparison* (2001), <http://www.unidroit.org/english/publications/review/articles/2000-3.htm> (stating that many articles in the UCL are “similar in spirit to the UNIDROIT Principles”).

52. BING LING, *supra* note 46, at 15.

53. *Id.*

54. *Id.*

55. WEI LUO, *supra* note 20, at 11–12 (noting that foreign contracts had been subject to greater Chinese administrative scrutiny).

56. *Id.* at 12 (noting that the UCL has 428 articles and the three previous contract laws had a total of 145 articles).

57. *Id.* (noting that the fifteen types of contracts include: sale, gift, loan, leasing, financial leasing, contractors’ agreement, construction, transportation, technology, custodial, warehousing and storage, consignment, trading, agency, and brokerage).

58. The major principle terms adopted by the UCL are equality (Art. 3), fairness (Art. 5), honesty and faithfulness (Art. 6), and limited freedom of contract (Art. 4). WEI LUO, *supra* note 20, at 12–13. China borrowed these principles from the CISG and from the U.C.C. *Id.* The principle of equality requires that all parties be in equal position. *Id.* at 12. The principle of freedom of contract has limitations. *Id.* at 13. For example, some parties may require approval by a Chinese government agency before their contracts are deemed valid. *Id.*

59. UCL, art. 11 (P.R.C.).

lieve that the UCL will facilitate the transition from a planned economy to a market economy while integrating the Chinese economy into the world economy.<sup>60</sup>

The UCL gives parties more freedom and flexibility in their contractual relations than existed prior to its enactment.<sup>61</sup> This enhanced freedom and flexibility to contract is articulated through principles of *fostering transactions* and *freedom of contract*, and demonstrated through some pronounced changes introduced by the UCL. Examples of those changes include: abolishing the differences between foreign and domestic contracts; allowing oral contracts;<sup>62</sup> limiting contract invalidation through the introduction of voidable contracts;<sup>63</sup> and restricting breaches that justify a termination of the contract if one party still wants to go forward.<sup>64</sup>

## II. CONTRACT LAW CONVERGENCE AND VARIATION

Contract law is a broad topic under any system, but this topic is even more complex when systems are compared. Although many of the provisions of the UCL mirror those of the Uniform Commercial Code<sup>65</sup> and the Restatement (Second) of Contracts,<sup>66</sup> there are also significant differences in both their texts and general effectiveness.

Section A discusses basic issues of contract formation. Section B addresses the elusive concept of good faith obligations. Section C discusses performance and nonperformance, focusing on discharge and breach of duties, substantial performance, and selected excuses for non-performance. Section D addresses the important issue of contractual remedies.

### A. CONTRACT FORMATION

#### 1. *Basic Elements*

Chinese scholars distinguish formation (*chengli*) of a con-

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60. WEI LUO, *supra* note 20, at 14.

61. See Hitchingham, *supra* note 51, at 2-3.

62. UCL, art. 10 (P.R.C.).

63. *Id.* art. 52.

64. *Id.* art. 94.

65. U.C.C. (1977).

66. RESTATEMENT (SECOND) OF CONTRACTS (1981).

tract from its effectiveness (*shengxiao*).<sup>67</sup> Formation occurs when the parties mutually consent to the essential terms of the contract.<sup>68</sup> For a contract to be effective, it must satisfy several conditions prescribed by law.<sup>69</sup> Thus, a contract may be formed without having a legally binding effect.<sup>70</sup>

Three elements must be present in order to form a contract: the parties,<sup>71</sup> the agreement,<sup>72</sup> and the object.<sup>73</sup> Most contracts are formed according to an offer and acceptance model.<sup>74</sup> An offer under the UCL is a “person’s declaration of intention to conclude a contract with another person.”<sup>75</sup> This definition is almost identical to that found in the UNIDROIT Principles.<sup>76</sup> Chinese

67. BING LING, *supra* note 46, at 59.

68. *Id.*

69. *Id.* Some contracts, especially those with foreign entities, require governmental approval. *Id.* at 99–100.

70. *Id.* at 59 (noting that a contract may be formed when A accepts B’s offer despite the fact that one or both parties do not have the capacity to enter into the contract).

71. *Id.* at 61. A contract requires at least two parties. *Id.* at 61. Unilateral acts are not contracts but they still have legal effects. *Id.* A unilateral act is a mere declaration of intention by one party. *Id.* Some unilateral acts include: the making of a will, the termination of a contract, and the release of debtors from their debts. *Id.*

72. *Id.* Agreement is the most important element. *Id.* It is satisfied when there is mutual consent between the parties. BING LING, *supra* note 46, at 61. There are various means of achieving an agreement: (i) the rule of offer and acceptance was introduced by the UCL; (ii) the offer-acceptance rule is not the only process utilized for reaching an agreement; (iii) conduct of the parties (rather than an express offer and subsequent agreement) may be sufficient to show agreement. *Id.* at 62–63.

73. *Id.* at 61. The object (*biaodi*) of a contract is the content, the particular transaction or relation. *Id.* at 63. The object must be specific enough so that a court may recognize it and enforce the contract. *Id.* However, a contract may be formed even though the parties have not indicated an agreement to all elements of the transaction. *Id.*

74. UCL, art. 13 (P.R.C.) (“The parties conclude the contract by means of offer and acceptance.”); *id.* art. 32 (“Where the parties conclude a contract in the form of a contract, the contract is concluded when the parties sign or seal the formal contract.”); *see also id.* art. 33 (“If the parties conclude a contract in the form of letters, data messages and so forth, they may request an execution of a confirmation note before the contract is formed. The contract is formed when the confirmation note is executed.”); *cf.* UNIDROIT PRINCIPLES, art. 2.1 (“A contract may be concluded either by the acceptance of an offer or by conduct of the parties that is sufficient to show agreement.”).

75. UCL, art. 14 (P.R.C.).

76. BING LING, *supra* note 46, at 64 (noting that per Article 14 of the UCL, the content of the declaration of intention to conclude a contract must be specific and definite and that it must indicate that the offeror will be bound by it upon acceptance by the offeree); *see also* UNIDROIT PRINCIPLES, art. 2.2 (“A proposal for concluding a contract constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance.”).

law generally considers "offers" made to unspecified persons, that is, to the public at large, to be *invitations* to offer, rather than offers *per se*.<sup>77</sup> However, some commercial advertisements are capable of becoming offers when their content conforms to the provisions for offers.<sup>78</sup> Thus, the determinative factor is not whether a proposal was made to a specific person, but rather, whether the proposal meets the two requirements of the declaration of intention under the UCL:<sup>79</sup> 1) its content is *specific*<sup>80</sup> and *definite*,<sup>81</sup> and 2) it indicates that the offeror will be *bound* by it upon acceptance by the offeree.<sup>82</sup>

In China, price lists are generally invitations to make offers.<sup>83</sup> Auctions, invitations to tender, and share prospectuses likewise presumptively are invitations to make an offer.<sup>84</sup> Like the U.S. system, commercial advertisements in China are mere invitations unless they have more specific and definite terms, such as "first come first served." The key is whether the offeror had the intention to be bound by the commercial advertisement and this can be determined by the language of the offer.<sup>85</sup> Advertisements for rewards are offers and the advertiser is bound to give the reward to those who comply, but it is unclear whether in China the person who complied must have been

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77. UCL, art. 15(1) (P.R.C.) ("Delivered price lists, auction announcements, announcements of invitation to tender, share prospectuses, commercial advertisements and so forth are invitations to offer.").

78. *Id.* art. 15(2) ("Commercial advertisements whose content conforms to the provisions for offers are deemed as offers."); *cf.* CISG Art. 14(2) ("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.").

79. UCL, arts. 14(1) & (2) (P.R.C.).

80. All principle terms do not necessarily have to be expressly stated since they can be supplied by interpretation of the contract and usages of transaction. Article 61 of the UCL states that the parties can supplement unclear or missing terms. *Id.* art. 61. Article 62 states that missing terms may be obtained through state or industry standards. *Id.* art. 62; BING LING, *supra* note 46, at 65 (stating, for example, "a proposal to sell an unspecified quantity of goods can still be a valid offer if the quantity offered can be ascertained through a relevant usage of transaction.").

81. The terms of a declaration of intention cannot be ambiguous.

82. The intention is to be found in the offeror's outward expression. However, the offeror's intention may be inferred from the circumstance rather than from his or her express declaration. If a proposal is specific and definite but the offeror has no intention to be bound, the proposal will probably be deemed an invitation to make an offer.

83. BING LING, *supra* note 46, at 66; *see also id.* at 67 (noting that price lists that are displayed in a shop should be treated as offers because they indicate a higher degree of an intention to be bound upon acceptance).

84. *Id.* at 67.

85. *Id.* at 68.

aware of the reward.<sup>86</sup> Similar to the U.S. system, in the UCL an offeror's intention to be bound is the most critical element of an offer and distinguishes an offer from an invitation to make an offer.

In general, contract law in the United States requires that a performance or a return promise be *bargained for*, that is, sought by the promisor in exchange for his or her promise and given by the promisee in exchange for that promise.<sup>87</sup> The UCL, however, has no explicit requirement of consideration.

## 2. Variation of Contract Forms: Statute of Frauds

Prior to the UCL, each of the Pre-1999 Contract Laws required all contracts to be in writing.<sup>88</sup> Article 10 of the UCL provides that the parties may use written, oral, and other forms of contracts. However, other laws or administrative regulations may require the use of written form. Also, if the parties agree to use the written form, then they must use the written form.

In comparison, in the United States, most state statute of frauds sections contain the following provisions:

- 1) An agreement that by its terms is not to be performed within a year from the making thereof;
- 2) A special promise to answer for the debt, default, or miscarriage of another . . . ;
- 3) An agreement made upon consideration of marriage;
- 4) An agreement for the leasing for a longer period than one year, or for the sale of real property . . . .<sup>89</sup>

In China, under the UCL Specific Provisions, contracts dealing with loans, leases over six months, and technological developments are required to be in writing.<sup>90</sup> Contracts dealing with se-

86. *Id.* (noting that in *Li Min v. Zhu Jinhua* the court held that plaintiff's act of finding and returning the briefcase was valid acceptance of the offer).

87. A contract requires a bargain in which there is a manifestation of mutual assent to the exchange as well as consideration. RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981). There are situations in which contracts without consideration are valid. *Id.* §§ 82-94.

88. BING LING, *supra* note 46, at 96.

89. CLAUDE D. ROHWER & ANTHONY M. SKROCKI, CONTRACTS 195-96 (5th ed. 2000).

90. Contracts that must be in writing are loan contracts, UCL, art. 197(1) (P.R.C.); lease contracts with a term of lease of over six months, *id.* art. 215; contracts of financial leasing, *id.* art. 238(2); construction project contracts, *id.* art. 270;



curities, housing, and insurance are among those required to be in writing according to "laws and administrative regulations."<sup>91</sup>

Chinese courts often void oral contracts where such contracts are required to be in writing.<sup>92</sup> However, courts have used oral evidence as evidence of the existence of principle terms in written contracts.<sup>93</sup> It is not clear whether this "substituted evidence rule" will continue to apply under the UCL since it is contrary to the underlying legislative policy which encourages the use of written contracts.<sup>94</sup>

## B. GOOD FAITH AND FAIR DEALING

The Chinese good faith doctrine existed in one of the Pre-1999 Contract Laws, the ECL, which stressed a written contract requirement in order to prevent fraud and bad faith.<sup>95</sup> Under the ECL, the parties were required to conform to the principles of equity and mutual benefit during contracting.<sup>96</sup> This strong emphasis on good faith dealing carried over from the ECL and other Chinese laws into the UCL.<sup>97</sup>

Some scholars attribute the Chinese emphasis on good faith dealings to Chinese cultural norms.<sup>98</sup> The Chinese traditionally

contracts for the supervision of construction projects, *id.* art. 276; contracts for technological development, *id.* art. 330(3); and contracts for the transfer of technology, UCL, art. 342(2) (P.R.C.).

91. BING LING, *supra* note 46, at 97 (noting that contracts that must be in writing are contracts for the assignment of land-use rights, Urban Housing Administration Law, art. 15(1) (P.R.C.); contracts for the transfer of housing, *id.* art. 40; security contracts, Security Law, arts. 13, 38, 64(1) (P.R.C.); insurance contracts, Insurance Law, art. 12 (P.R.C.); partnership contracts, Partnership Enterprise Law, art. 3 (P.R.C.); labor contracts, Labour Law, art. 19 (P.R.C.); advertisement contracts, Advertisement Law, art. 20 (P.R.C.); contracts for the transfer, mortgage or lease of ships, Maritime Law, arts. 9(2), 12(2), 43, 128 (P.R.C.); or aircraft, Civil Aviation Law, arts 14(2), 26 (P.R.C.); and contracts for the authorization of auction, Auction Law, art. 42 (P.R.C.)). Some contracts must be registered in order to give notice to the public of the alteration of "real rights." *Id.* at 100–01. The legal effect of an unregistered contract may vary. For example, the contract may not be effective or it may not be invoked against other parties. However, parties are allowed to register a contract after legal proceedings involving it have begun, but such registration must take place before the trial is concluded. *Id.* at 103–04.

92. *Id.* at 103.

93. *Id.* at 104.

94. *Id.* at 105.

95. Feng Chen, *supra* note 16, at 160.

96. *Id.* at 161.

97. *See generally id.*

98. *See generally* Cheng Lu Wang et al., *Conflict Handling Styles in International Joint Ventures: A Cross-Cultural and Cross-National Comparison*, 45 MGMT INT'L REV. 3 (2005).

resolve disputes through negotiations held in good faith, which offers the advantage of neither side losing face.<sup>99</sup> This cultural norm would explain why Chinese contract law appears to be more flexible than contract law in the West, and therefore how formal contracts are less likely to be effective in certain situations.<sup>100</sup>

Perhaps more important is the cultural difference in the perception of contracts in general. The Chinese view contracts and legalism negatively, and as something of a last resort, reverting to a written contract only if personal relations and verbal agreements fail.<sup>101</sup> Some scholars submit that the end of contract formation (signing) is the culmination of the process for Westerners, but it is just the beginning of the process for the Chinese.<sup>102</sup> A written contract to the Chinese means the beginning of a relationship, not the end of negotiations at all. Without good faith, the relationship cannot occur, and therefore a contractual relationship must be preceded by a societal relationship,<sup>103</sup> implying that good faith is an implicit prerequisite to contract creation.

The good faith doctrine permeates the UCL. The first chapter of the UCL, Common Provisions, sets out the law's purpose and guiding principles. One overarching principle of the UCL is good faith and fairness. Article 6 states, "The parties shall observe the principle of good faith in exercising their rights and fulfilling their obligations."<sup>104</sup> In addition to Article 6, the doctrine of good faith permeates the contract law in numerous explicit and implicit ways. Major provisions of the UCL embody the principle of good faith with respect to every stage of the contracting process, i.e., preliminary negotiations, formation, and termination.<sup>105</sup> Even standard contract terms are governed by

99. *Id.* at 6.

100. *Id.* at 11–12.

101. *Id.* at 12.

102. Pattison & Herron, *supra* note 8, at 491.

103. *Id.* at 486.

104. UCL, art. 6 (P.R.C.); see Wang Liming & Xu Chuanxi, *supra* note 35, at 16–22 ("By embracing the principle of good faith, the [China] Contract Law is recognizing China's traditional morality and business ethics, which is also consistent with the norms of international commercial practice. With its strong moral force, the principle of good faith can be expected to contribute much to the establishment of a normal transactional order in China."). In forming the contract, good faith duties include loyalty, honesty, non-deception, keeping promises, and confidentiality. *Id.* at 17–19.

105. Lee, *supra* note 11, at 970.

the principle of fairness.<sup>106</sup>

The UCL does not provide a precise definition of good faith. Some scholars believe that this lack of precision around the concepts of good faith and fairness creates difficulties in contractual relations. Vague concepts allow judges wide latitude to interpret the term and too much discretion, setting a framework for at least imprecision, if not corruption.<sup>107</sup>

Additionally, several articles of the UCL, covering both general and specific provisions, explicitly state that the good faith doctrine shall apply. The UCL requires good faith in the formation of a contract, specifically in the use of standard clauses and contract terms (as detailed in Articles 39–41).<sup>108</sup> The law prohibits a party from conducting negotiations in bad faith or with malicious intent.<sup>109</sup> Upon termination of a contract, the parties still owe each other good faith duties such as loyalty and confidentiality.<sup>110</sup>

The concepts of fairness and good faith also reveal themselves in more subtle ways in the UCL. Fraud, which is an expression of bad faith and harmful to the interests of the state, invalidates the contract.<sup>111</sup> Certain contractual liability exemptions also invalidate a contract, presumably because they are unfair.<sup>112</sup>

106. *Id.*

107. As a "borrowed term" from Western law, some believe that there is no history of interpretation in China of the fairness term, leaving contractual duties and responsibilities too loosely defined. *Id.* at 981. Others claim that familiarity with the term may lead western lawyers to assume too much or associate the wrong standard with a particular concept. Hitchingham, *supra* note 51, at 5.

108. UCL, arts. 39–41 (P.R.C.).

If standard clauses are used in making a contract, the party that provides the standard clauses shall determine the rights and obligations between the parties in accordance with the principle of fairness, and shall call in a reasonable manner the other party's attention to the exemptible and restrictive clauses regarding its liability, and give explanations of such clauses at the request of the other party.

*Id.* art. 39 (P.R.C.).

109. *Id.* art. 42 ("In the making of a contract, the party that falls under any of the following circumstances, causing thus loss to the other party, shall hold the liability for the loss, (1) engaging in consultation with malicious intention in name of making a contract . . .").

110. *Id.* art. 92 ("After the termination of rights and obligations under a contract, the parties shall perform the duties of notification, assistance and confidentiality in light of the principle of good faith and in accordance with trade practices.")

111. *Id.* art. 52 ("A contract is invalid under any of the following circumstances: (1) either party enters into the contract by means of fraud or coercion and impairs the State's interests . . .").

112. *Id.* art. 53 ("The following clauses on liability exemption in a contract shall

The UCL recognizes the general principle of freedom of contract and forbids any entity or individual to interfere with this right.<sup>113</sup> But even freedom of contract is regulated by the requirements of equality and fairness in the UCL, which limits this very freedom of contract by requiring equal legal status and equal bargaining power of the parties.<sup>114</sup>

In comparison, very early American contract law encouraged people to act responsibly, but it was reluctant to proscribe behaviors. "The common law had traditionally been reluctant to recognize, at least as overt doctrine, any generalized duty to act in good faith toward others in social intercourse."<sup>115</sup> However, twentieth century developments in contract law discouraging illusory promises, unconscionability, duress, etc., led to greater acceptance of standards of good faith and fairness in contracting.<sup>116</sup> Today U.S. courts have deemed that in every contract, there is an implied undertaking that each party exercise what is deemed "good faith" or "good faith and fair dealing."<sup>117</sup> The U.C.C. also provides that every contract governed by it "imposes an obligation of good faith in its performance."<sup>118</sup> This implied requirement for parties to act in good faith is based on "fundamental notions of fairness."<sup>119</sup> Under the U.C.C., the implied duty to act in good faith may not be disclaimed by agreement, but the "parties, by agreement, may determine the standards by which the performance of [an obligation] is to be measured if those standards are not manifestly unreasonable."<sup>120</sup>

American recognition of the good faith principle also occurs in the form of the Restatement (Second) of Contracts.<sup>121</sup> While

be invalid: (1) those causing physical injury to the other party; or (2) those causing losses to property to the other party by intention or due to gross negligence.").

113. *Id.* art. 4 ("The parties shall, pursuant to law, have the right to enter into a contract on their own free will, and no unit or person may unlawfully interfere.").

114. UCL, art. 3 (P.R.C.) ("The parties to the contract have equal legal status, and neither party may impose its will on the other.").

115. Eric S. Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 384 (1978).

116. JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 474 (2003).

117. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

118. U.C.C. § 1-203 (2000).

119. E. ALLAN FARNSWORTH, CONTRACTS 489 (4th ed. 2004).

120. U.C.C. § 1-302(b) (2000).

121. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). The Duty of Good Faith and Fair Dealing provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." *Id.* The comment to that section explains that:

The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement

the language of contract law is as vague in the United States as in China, the U.S. doctrine of good faith generally serves as an inherent, rather than a stand-alone duty, requiring honesty and decency in contracting relationships based on standards of reasonableness.

There are, however, important distinctions between Chinese and American understandings of good faith. Chinese contract law incorporates the principle of fairness and good faith into all phases of contracting: pre-contractual negotiations, formation and performance, and even after contract termination.<sup>122</sup> In contrast, American contract law does not impose good faith requirements at the pre-contractual stage, but requires good faith dealings in contract formation and performance.<sup>123</sup> Good faith is not a concept applied in American contract law post-termination.<sup>124</sup>

### 1. Negotiations

"Negotiation of contracts" refers to the whole negotiation process leading up to the conclusion of a contract.<sup>125</sup> The process usually begins with an offer, or invitation, followed by an acceptance or counter-offer, and ends with the conclusion of contract.<sup>126</sup> This distinction between Chinese and American contract law regarding negotiating in good faith is significant, as Chinese contract law imposes obligations, and American contract law does not.

Liability arising from negotiation of a contract is a new feature of the UCL.<sup>127</sup> The UCL imposes certain liabilities even be-

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of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

122. Lee, *supra* note 11, at 970. For example, as to post-termination obligations, the UCL states: "After the termination of rights and obligations under a contract, the parties shall perform the duties of notification, assistance and confidentiality in light of the principle of good faith and in accordance with trade practices." UCL, art. 92 (P.R.C.).

123. See *supra* notes 114-15 and accompanying text.

124. See, e.g., Feng Chen, *supra* note 16, at 186.

125. John S. Mo, *The Code of Contract Law of the People's Republic of China and the Vienna Sales Convention*, 15 AM. U. INT'L L. REV. 209, 225 (1999).

126. *Id.*

127. *Id.* at 266.

fore a contract is formed, based on the principle of good faith. The breaching party can now be held liable for losses caused to the innocent party.<sup>128</sup>

UCL Article 42 is designed to protect the party in the event the negotiations do not lead to conclusion of a formal contract, to prevent concealment of important facts, and to prevent parties from pretending to negotiate with ill intent. Article 42 states that a party is prohibited from conducting negotiations in bad faith under the false pretense of entering a contract.<sup>129</sup> Also, a party must not conceal any material fact relating to the conclusion of the contract or provide false information.<sup>130</sup> Lastly, a party incurs liability for any conduct in the course of negotiations contrary to the principle of good faith.<sup>131</sup> This last principle has two aspects: (1) a duty to cooperate in forming and performing a contract in order to carry out its purpose; and (2) an acknowledgment that a court has broad powers to fill gaps in the law, interpret contracts according to fairness principles, and override unfair provisions in the contract.<sup>132</sup>

Equally significant is Article 43, which prohibits a party from disclosing or improperly using any trade secret that the party has become aware of in the course of negotiating a contract, regardless of whether a contract has been formed.<sup>133</sup> This is similar to the common law tradition of "duty of confidentiality," with a twist.<sup>134</sup> The difference is that a Chinese court may decide what is reasonable to keep confidential, whereas in common law tradition, the parties would be expected to clearly declare their commercial secrets in order to avoid dispute.<sup>135</sup>

American law disclaims any general duty of "good faith" in

128. See generally Mo, *supra* note 125.

129. UCL, art. 42(1) (P.R.C.) ("Where in the course of concluding a contract, a party engaged in any of the following conducts, thereby causing loss to the other party, it shall be liable for damages: (i) negotiating in bad faith under the pretext of concluding a contract; (ii) intentionally concealing a material fact relating to the conclusion of the contract or supplying false information; (iii) any other conduct which violates the principle of good faith.").

130. *Id.* art. 42(2).

131. *Id.* art. 42(3).

132. See Lam Wing Wo, *Scrutinizing the Contract Law: Scope, Offer and Acceptance, Invalid Contracts, Agency, and Consequences of Breach*, CHINA LAW & PRACTICE, Aug. 1999, at 59.

133. UCL, art. 43 (P.R.C.) ("A party may not disclose or improperly use any trade secret which it became aware of in the course of negotiating a contract, regardless of whether a contract is formed. If the party disclosed or improperly used such trade secret, thereby causing loss to the other party, it shall be liable for damages.").

134. Mo, *supra* note 125, at 267-68.

135. *Id.* at 267.

the negotiation of commercial agreements.<sup>136</sup> The Restatement (Second) indicates that American law does not obligate parties to negotiate with one another in good faith prior to entering into a valid contract,<sup>137</sup> nor is good faith required in the formation of a contract.<sup>138</sup>

"In a business transaction both sides presumably try to get the best deal . . . . The proper recourse [for outrageous conduct] is to walk away from the bargaining table, not sue for 'bad faith' in negotiations."<sup>139</sup> The general rule assumes a lack of fraud. In American contract law, "fraud that is egregious will lead a contract to be voided,"<sup>140</sup> but that is distinct from negotiation in good faith. Fraud limitation in American law is somewhat similar to the UCL's Article 42(2) limitation against "concealing intentionally key facts related to the making of the contract or providing false information,"<sup>141</sup> but fraud is a much stricter classification than the good faith requirement of the UCL. Remedies for bad faith are found in the American law of torts or restitution, not contract law.<sup>142</sup>

## 2. Contract Formation and Validity

The UCL intended to make contracting more flexible and encourage a more stable contracting environment than previously existed in China. To that end, the UCL has incorporated the principles of good faith and fairness explicitly in the area of contract terms. In the past, a contract would be nullified without any of several proscribed contractual terms included in the written contract. Now, the *proscribed* list of terms is only a suggested list of terms. Article 39 permits a contract to contain standard terms or clauses, such as for buying and selling consumer goods, which are prepared in advance and not negotiated in concluding the contract.<sup>143</sup>

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136. G. RICHARD SHELL, *BARGAINING FOR ADVANTAGE* 206 (1999).

137. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

138. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1981).

139. SHELL, *supra* note 136, at 206 (quoting an American judge).

140. Feng Chen, *supra* note 16, at 177.

141. UCL, art. 42(2) (P.R.C.).

142. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1981).

143. The UCL states:

[I]f standard clauses are used in making a contract, the party that provides the standard clauses shall determine the rights and obligations between the parties in accordance with the principle of fairness, and shall call in a reasonable manner the other party's attention to the exemptible and re-

However, even the use of standard terms is regulated by the fairness doctrine. UCL Article 40 states that “standard clauses shall become invalid if they fall under any of the circumstances set forth in Articles 52 and 53 of this Law or if the party that provides the standard clauses exempts itself from the liability, imposes heavier liability on the other party, or precludes the other party from its main rights.”<sup>144</sup> Articles 52 and 53 invalidate a contract concluded under fraud or contrary to public policy.<sup>145</sup>

Where a dispute arises over the construction of a standard term, the term is interpreted according to common usage. This implies that the UCL, in accordance with the principle of fairness and good faith, favors the disadvantaged party, and the Chinese courts have discretion to rectify what it perceives as unfairness in standard contract terms. This activity is commonly referred to as “gap filling.”<sup>146</sup> Western lawyers fear that gap filling makes it too difficult to assess risks in contracting, because it is unclear exactly how Chinese courts will fill in the gaps. For example, the Supreme People’s Court has not interpreted new standards of “usage of trade,” “customary standards,” or “method conducive to the achievement of the objective of the contract,”<sup>147</sup> meaning that the courts are free to interpret the terms on a case-by-case basis.

The UCL makes a clearer distinction between contract formation and contract validity than previous law by introducing the distinction between void and voidable contracts, whereas previous law simply voided all non-conforming contracts. Contracts that are still void *per se* are those made through fraud or duress, through bad faith collusion, and those that are illegal, harm the public interest, or violate mandatory law or regulation.<sup>148</sup> But under the UCL, even unfair contracts can be voided

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strictive clauses regarding its liability, and give explanations of such clauses at the request of the other party. ‘Standard clauses’ means the clauses that are formulated in anticipation by a party for the purpose of repeated usage and that are not a result of consultation with the other party in the making of the contract.

UCL, art. 39 (P.R.C.)

144. *Id.* art. 40.

145. *Id.* arts. 52, 53.

146. *See, e.g.,* Hitchingham, *supra* note 51, at 12.

147. *Id.* at 3–4; *see also* The Processing Plant of Constr. Timber of Xinjiang Uygur Autonomous Region v. The Head Office of Xinjiang Indus. Dev. Corp. of the Chinese Democratic League, CNLCAS 193 (Sup. People’s Ct., Dec. 1, 2001) (applying the fairness doctrine to “gap fill”).

148. UCL, art. 52 (P.R.C.).



by the disadvantaged party.<sup>149</sup> Therefore, even a duly formed contract might not be valid based on the State's evaluation and attitude.

The philosophy of American contract law dictates that contracts are voluntary; parties need mutual agreement to create an enforceable contract. As such, American courts look for implicit good faith offers and good faith acceptances in formation. Good faith is judged by a reasonableness standard, and courts rely heavily on the record of communication between the parties to judge intent. "The law, therefore, judges an agreement between two persons exclusively from those expressions of their intentions which are communicated between them."<sup>150</sup>

An example of how American contract law implicitly embeds the principle of good faith in contract law is demonstrated through the "unconscionability" defense. Similar to UCL stipulations on standard terms, unconscionability attempts to prevent an absence of meaningful choice on the part of one party and unreasonably favorable contract terms to the other party. If a court finds that a contract or clause is too one-sided or so unfair as to be *unconscionable*, the court may decline to enforce that contract or clause as a matter of judicial policy.<sup>151</sup> Some critics could draw an analogy between this action and the Chinese practice of "gap filling."

### 3. Performance and Termination of Contracts

Both Chinese and American contract law emphasize full performance in good faith, and the respective doctrines in this area are quite similar. Chinese contract law, through the UCL, now recognizes a standard of good faith in contract performance. Under the UCL, contract performance may be the prime area where good faith comes into play. The UCL provides for order of performance and performance standards and duties,<sup>152</sup> and under the UCL, upon the termination of a contract the parties still owe to each other such good faith duties as loyalty and confidentiality.<sup>153</sup>

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149. *Id.* art. 54 ("Either party has the right to request a people's court or an arbitration institution to alter or rescind any of the following contracts: (1) any contract which is made under substantial misunderstanding; or (2) any contract the making of which lacks fairness.").

150. See *Lucy v. Zehmer*, 84 S.E. 2d 516, 522 (Va. 1954) (citations omitted).

151. RESTATEMENT (SECOND) OF CONTRACTS § 178 (1981).

152. Hitchingham, *supra* note 51, at 13.

153. UCL, art. 92 (P.R.C.) ("After the termination of rights and obligations un-

UCL Article 60 stresses full performance. "The parties shall fulfill fully their respective obligations as contracted. The parties shall observe the principle of good faith and fulfill the obligations of notification, assistance and confidentiality in accordance with the nature and aims of the contract and customary trade practices."<sup>154</sup> Another example of the good faith duty is a duty of notification found in Articles 79 and 80 concerning assignment and delegation of a contract. Assignment is permitted with notification except where the law or a contract prohibits it.<sup>155</sup>

A party may file a claim where the other party failed "to perform its obligations under the contract or fails to perform them as contracted."<sup>156</sup> Significant in this provision is that a party may be liable for acting in bad faith, and the UCL does not require fault to prove a breach.<sup>157</sup> In the case of early or partial performance, the first principle applied is that of liability, or fault. However, when fault is undeterminable, the courts will evoke the principle of good faith to assign losses.<sup>158</sup>

American contract law, like Chinese contract law, expects full performance. Full performance should be at the level of typical business practice. For example, parties negotiating for a modification to an existing contract are bound by good faith, because there is an existing contract, and full performance of that existing contract is the first expectation. A party may even be required to take affirmative steps to achieve the goals that are stated in the contract, based on a duty of good faith performance.

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der a contract, the parties shall perform the duties of notification, assistance and confidentiality in light of the principle of good faith and in accordance with trade practices.").

154. *Id.* art. 60; see also Yu Cunku v. Dong Chengbin & Dong Chengzhen, CHINALAWINFO (find at <http://chinalawinfo.com> (ID: CNLCAS 138)) (Deyang Interim People's Ct., Aug. 30, 2001) (noting that parties have a *good faith duty* to notify each other of changes to critical information during the performance of a contract).

155. UCL, art. 80 (P.R.C.) ("Any transfer of rights by a creditor shall be notified to the debtor. The transfer shall not bind the debtor without such notification.").

156. UCL, art. 107 (P.R.C.) ("Either party that fails to perform its obligations under the contract or fails to perform them as contracted shall bear the liability for breach of contract by continuing to perform the obligations, taking remedial measures, or compensating for losses.").

157. Hitchingham, *supra* note 51, at 17-18.

158. See Binhai Entm't Co., Ltd. of Haikou City, Hainan Province v. Hainan Huaxin Realty Mgmt. Co., CHINALAWINFO (find at <http://chinalawinfo.com> (ID: CNLCAS 195)) (Sup. People's Ct., May 16, 2001) (resorting to the principle of fairness in a case involving a failed contract with ambiguous terms and a change in national policy caused mutual breaches).

American contract law also requires a good faith obligation when asserting contract claims and defenses. This obligation is violated by dishonest conduct "such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts."<sup>159</sup> "It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification . . . ."<sup>160</sup>

The UCL clearly states that the duty to act in good faith will generally give rise to certain duties which are ancillary to the contract's principal obligations.<sup>161</sup> It specifically mentions "notification, assistance, and confidentiality," but other ancillary duties will also arise depending on the nature of the contract.<sup>162</sup> The duty of notification requires a party to notify the other of any information that is material to the performance of the contract.<sup>163</sup> The duty of assistance is a limited duty to provide cooperation where it is expected by virtue of the nature and purpose of the contract and usage of trade.<sup>164</sup> The duty of confidentiality requires that parties maintain the confidentiality of all confidential information received from the other party in the course of the conclusion and performance of the contract.<sup>165</sup>

The UCL also stipulates that the duty of good faith may apply after the contract has been terminated.<sup>166</sup> For example, after the termination of an employment contract, the good faith obli-

159. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. e (1981).

160. *Id.*

161. BING LING, *supra* note 46, at 231–32.

162. *Id.*; see *Qinghai Sec. Co. Ltd v. Wuhan Zhongtianyuan Accounting Co. Ltd.* Concerning Disputes over the Transfer of Contracts and the Comp. for Infringement, CHINALAWINFO (find at <http://chinalawinfo.com> (ID: CNLCAS 187)) (Sup. People's Ct., July 7, 2002) (holding one of the parties to be jointly and severally liable for the breach of duties of notice, assistance and maintaining confidentiality of the contract, based on the good faith principle and Article 60 of the Contract Law).

163. BING LING, *supra* note 46, at 232–33. In *Hailin Co. v. Xiaoxing Co.*, the court interpreted the duty of good faith to require that a buyer of goods using a letter of credit assigned by another party provide notice to the seller and obtain the seller's consent. *Id.* at 232. Various types of contracts impose specific duties of notice. See UCL, arts. 162, 180, 228(2), 230, 257, 338, 373, 389, 401 (P.R.C.).

164. BING LING, *supra* note 46, at 233.

165. *Id.* at 234. Additional duties arising from the duty of good faith, but not specifically named in the UCL, include a duty not to hinder the performance of the other party. Additionally, a buyer must take reasonable steps to preserve rejected goods following the rejection, and a party must perform the contract in the way that is most conducive to the purpose of the contract if that party has multiple means of performance. *Id.*

166. See UCL, art. 92 (P.R.C.); BING LING, *supra* note 46, at 332; Feng Chen, *supra* note 16, at 186; Wang Liming & Xu Chuanxi, *supra* note 35, at 21.

gation may impose post-contractual liability on an employee to maintain the confidentiality of the employer's trade secrets.<sup>167</sup>

#### 4. Summary on Good Faith

The principles of good faith and fairness in Chinese contract law are identical to the American doctrine. In formation and performance both legal systems expect good faith conduct. There are some non-trivial differences between the application of the two doctrines, particularly in pre- and post-contractual good faith obligations, where Chinese law demands a higher standard of conduct.

Despite the differences, both systems use good faith as an over-arching principle of contract law through the UCL, the U.C.C., the Restatement (Second), and common law jurisprudence. In both systems, good faith purportedly covers the spectrum of contract phases. Both systems use a subjective standard of good faith (except in the U.C.C. where the sale of goods also incorporates an objective standard). Both systems are criticized for being vague; both rely strongly on a sense of honesty and reasonableness, and neither system relies heavily on good faith as a stand-alone obligation.

### C. PERFORMANCE AND NONPERFORMANCE

U.S. contract law normally incorporates the principle of *pacta sunt servanda* ("agreements are to be observed") or simply, "a deal is a deal."<sup>168</sup> Parties can obligate themselves by contract to specific performance obligations or alternatively limit their liability under certain events, for example, through the addition of *force majeure* clauses,<sup>169</sup> but otherwise the duty is clear. If such limitation is not expressly made in the contract, the parties are either bound to the contract or must rely on one of the court derived limitations, such as mistake or changed circumstances.<sup>170</sup>

The UCL also adopts *pacta sunt servanda* as one of its fundamental principles.<sup>171</sup> The provisions covering contract per-

167. See UCL, art. 92 (P.R.C.); BING LING, *supra* note 46, at 332; Wang Liming & Xu Chuanxi, *supra* note 35, at 21.

168. *Waukesha Foundry v. Indus. Energy*, 91 F.3d 1002, 1011 (7th Cir. 1996); FARNSWORTH, *supra* note 119, at 599.

169. FARNSWORTH, *supra* note 119, at 600.

170. *Id.*

171. See UCL, art. 8 (P.R.C.); BING LING, *supra* note 46, at 379.

formance largely echo many of "the corresponding rules in the UNIDROIT Principles."<sup>172</sup> Article 107 of the UCL sets out the general rule on liability for breaches, stating that "if a party fails to perform its obligations under a contract, or rendered non-conforming performance, it shall bear the liabilities for breach of contract by specific performance, cure of the non-conforming performance or payment of damages."<sup>173</sup>

### 1. Substantial Performance

Under U.S. law, full performance of a duty always operates as a discharge of that duty, but nonperformance does not always constitute a breach.<sup>174</sup> This is so because performance may not yet be due because the required time has not yet arrived, or because a condition may not yet have occurred. The duty may have also been otherwise discharged by such grounds as subsequent agreement of the parties, impracticability of performance, or frustration of purpose.<sup>175</sup> When performance is due, however, any nonperformance is a breach, no matter how insubstantial.<sup>176</sup>

China's UCL makes liability for nonperformance an obligation that is inherent in the binding nature of contracts.<sup>177</sup> Article 60 of the UCL mandates full performance according to the contract, lest a party be liable for breach under Article 107.<sup>178</sup> Article 107 adopts a strict liability principle, making breach the only essential element for contract liability.<sup>179</sup> This strict liability approach removes the need to find fault in the nonperforming party, which is required under the civil law tradition for liability for nonperformance of obligations; this approach was present in some Pre-1999 Contract Laws.<sup>180</sup> Article 107 also

172. Zhang Yuqing & Huang Danhan, *supra* note 51.

173. UCL, art. 107 (P.R.C.).

174. RESTATEMENT (SECOND) OF CONTRACTS § 235 (1981)

175. FARNSWORTH, *supra* note 119, at 535.

176. RESTATEMENT (SECOND) OF CONTRATS § 235 (1981).

177. BING LING, *supra* note 46, at 379.

178. The term "full" was added late in the drafting process in order to "emphasize the duty of complete performance." Potter, *supra* note 14, at I-6.2.03.

179. BING LING, *supra* note 46, at 382. This follows the practice of several of China's Pre-1999 Contract Laws. *Id.* at 382 n.23. In contrast, however, the ECL had required proof of: (i) breach; (ii) property damage; (iii) fault; and (iv) a causal link between the breach and the damage. *Id.* at 382 n.24.

180. *See id.* at 399-405; *see also supra* note 179; *cf.* Hitchingham, *supra* note 51, at 17-19 ("[T]he law does not provide a standard of proof for an injured party to justify termination . . . [and] if an aggrieved party in good faith terminates a contract but is without proper cause, the aggrieved party is liable because fault based negligence is no longer an issue.").

provides the non-breaching party with the freedom to choose various remedies for the breach, essentially abandoning the “[t]raditional mandatory rule of specific performance.”<sup>181</sup>

The UCL identifies circumstances by which duties may be discharged and contracts terminated without liability. A duty is discharged when (1) the obligations were performed in accordance with the contract; (2) the contract was terminated; (3) the obligations were set off against each other; (4) the obligor placed the subject matter in escrow in accordance with the law; (5) the obligee released the obligor from performance; (6) both the obligee’s rights and the obligor’s obligations were assumed by one party; and (7) any other discharging circumstance provided by law or proscribed by the parties occurred.<sup>182</sup> Articles 92 through 94 further provide parties with rights to terminate a contract without performing their obligations.

a. Substantial Performance under U.S. Contract Law

Common law courts developed the doctrine of substantial performance, whereby “if one party’s performance is a constructive condition of the other party’s duty, only ‘substantial’ performance is required before that party can recover under the contract.”<sup>183</sup> The aim of the doctrine is to prevent forfeiture and, accordingly, the doctrine considers the benefit received by the injured party.<sup>184</sup> The doctrine is primarily applied to service contracts, particularly to construction contracts.<sup>185</sup> It also has limitations, especially in contracts for the sale of goods, which adopt a perfect tender rule.<sup>186</sup>

Under U.S. law, a major factor determining if substantial performance can be applied is the extent to which the injured party can adequately be compensated in damages.<sup>187</sup> That is, if

181. Wang Liming & Xu Chuanxi, *supra* note 35, at 14.

182. UCL, art. 91 (P.R.C.).

183. FARNSWORTH, *supra* note 119, at 548.

184. *See id.*

185. *Id.*

186. *See* U.C.C. § 2-601 (2004). The perfect tender rule is not without criticism as it provides a buyer a right to reject goods without being harmed by the breach, and the seller might be stuck with perishable or specially manufactured rejected goods. *See* FARNSWORTH, *supra* note 119, at 552 (explaining buyer rights under the perfect tender rule); *see also* CISG, arts. 49(1)(a), 64(1)(a) (a party may “avoid” a contract and become free from further duties if the other party commits a “fundamental” breach); UNIDROIT PRINCIPLES, art. 7.3.1(1) (allowing a party to terminate a contract where the other party’s nonperformance is “fundamental”).

187. FARNSWORTH, *supra* note 119, at 548.

the breach is substantial and damages are uncertain or insufficient to pay for correction, a court is unlikely to find substantial performance.<sup>188</sup> An additional factor courts consider is whether the performance can be returned to and salvaged by the breaching party; if the breaching party can salvage the returned performance a court is less likely to find substantial performance.<sup>189</sup> Finally, if a party's breach was "willful," courts have generally determined that the performance cannot be considered substantial.<sup>190</sup>

#### b. Substantial and Partial Performance under the UCL

Under Chinese law, the extent to which a party's partial performance can allow it to recover under the contract is governed by rules covering "fundamental breach."<sup>191</sup> Chinese law looks to the following factors in considering whether a breach was fundamental: (1) the intended purpose of the contract;<sup>192</sup> (2) the importance of the unperformed obligation;<sup>193</sup> (3) the extent of nonperformance;<sup>194</sup> (4) the consequence of nonperformance;<sup>195</sup> (5) the likelihood of cure;<sup>196</sup> (6) the personal nature of the contract;<sup>197</sup> (7) the willfulness of breach;<sup>198</sup> and (8) the possibility and desir-

188. *Id.*

189. *Id.*

190. *Id.*

191. BING LING, *supra* note 46, at 344.

192. *Id.* at 340. If the parties intended a particular purpose, a breach that frustrates that purpose may be found to be fundamental. *Id.* For example, in *Yining Int'l Travel Agency v. Yili Great Wall Enter. Co.*, the court upheld a purchaser's termination of a contract that called for the delivery of standard residential flats when the construction company breached the contract by turning over luxury flats. *Id.*

193. *Id.* Different breaches are obviously of different value in terms of the obligations they break, and this will be highly dependent on the nature of the contract. *See id.* at 340-41.

194. BING LING, *supra* note 46, at 341. Again, this is dependent on the nature of the contract, as a fundamental breach of some contracts may be anything less than full performance. *See id.*

195. *Id.* The extent of detriment to the aggrieved party is an important factor, and the foreseeability of the consequences to the defaulting party may play a role in determining whether a breach is fundamental. *See id.*; *cf.* CISG, art. 25.

196. BING LING, *supra* note 46, at 342. If the defaulting party is able to cure the breach, it is by definition not "impossible to accomplish the purpose of the contract," and it is possible that a non-fundamental breach will be come a fundamental one if the defaulting party does not take action to cure the breach in time. *See id.*

197. *Id.* "If the contract involves personal confidence between the parties, a breach that compromises such confidence is likely to be fundamental." *Id.* This has particular relevance in insurance contracts. *Id.*

198. *Id.* The more willful, intentionally or grossly negligent the breach, the more likely it is to be found fundamental by Chinese courts. BING LING, *supra* note

ability of further performance.<sup>199</sup>

The UCL generally allows a party to reject less than complete performance of an obligation, but leaves the door open for a very wide exception. Article 72 states that “a creditor may reject the debtor’s partial performance, except where such partial performance does not harm the creditor’s interests.”<sup>200</sup> It should be noted that this provision refers to partial performance of an *obligation* rather than partial performance of the entire contract.<sup>201</sup> Article 72 discusses a failure to perform an obligation in the agreed quantity and assumes that performance of that obligation is divisible.<sup>202</sup>

Article 72’s right to reject partial performance gives the non-breaching party a right to demand full performance of the obligation at one time.<sup>203</sup> Although the partial performance will generally constitute a breach of contract and will therefore affect the creditor’s interest, the exception that the creditor may not reject partial performance when its interest is not harmed compares the creditor’s interest in accepting the partial performance with its interest in refusing the partial performance and insisting on full performance.<sup>204</sup> If the creditor’s interests are not harmed by accepting partial performance, good faith requires it do so lest it be liable for default in acceptance.<sup>205</sup> Article 72 states that “any additional expense incurred by the creditor due to the obligor’s partial performance shall be borne by the debtor” and the creditor is entitled to the related compensation whether it accepts or rejects the partial performance.<sup>206</sup>

Chapter 9 of the UCL sets out special rules with regard to partial performance of sales contracts that are similar to those followed in many civil law jurisdictions.<sup>207</sup> Article 164 provides that where there are principal things and accessory things, a fundamental nonperformance with regard to the principal thing will make the accessory thing worthless, and the aggrieved

46, at 342–43.

199. *Id.* at 343. If further performance is not possible due to the breach, the contract must be terminated; and even if further performance is possible, if the aggrieved party cannot obtain its expected interest from the contract, it may also be entitled to terminate the contract. *See id.*

200. UCL, art. 72 (P.R.C.).

201. *Id.*; *see also* BING LING, *supra* note 46, at 240.

202. *See* BING LING, *supra* note 46, at 240.

203. *Id.*; *cf.* U.C.C. § 2-307 (2004).

204. BING LING, *supra* note 46, at 241.

205. *Id.* at 241, 394–97.

206. UCL, art. 72 (P.R.C.); BING LING, *supra* note 46, at 242.

207. BING LING, *supra* note 46, at 344–45; *see* UCL, arts. 130–75 (P.R.C.).



party can terminate the contract with respect to the accessory thing.<sup>208</sup> However, if the breach is with respect to the accessory thing, the same would not apply to the principal thing. Article 165 states the general rule that if the subject matter can be separated without frustrating the purpose of the contract, the aggrieved party can only reject the performance that is defective.<sup>209</sup> Article 166 deals with installment contracts, stating:

Where the seller is to deliver the subject matter in installments, if the seller's failure to deliver or non-conforming delivery of one installment frustrates the purpose of the contract in respect of such installment, the buyer may terminate the portion of the contract in respect thereof.

If the seller's failure to deliver or non-conforming delivery of one installment frustrates the purpose of the contract in respect of all subsequent installments notwithstanding their delivery, the buyer may terminate the portion of the contract in respect of such installment as well as any subsequent installment.

If the buyer is to terminate the portion of the contract in respect of a particular installment which is interdependent with all other installments, it may terminate<sup>210</sup> the contract in respect of all delivered and undelivered installments.

### c. Comparison of Substantial Performance under U.S. and Chinese Contract Law

In comparing the factors that U.S. and Chinese courts consider in determining whether a breaching party's performance amounted to substantial performance, U.S. law places much more importance on the economic value involved—both in terms of whether damages can adequately compensate the aggrieved party for its losses and in terms of whether the breaching party can salvage its performance.<sup>211</sup> Chinese law, on the other hand, looks far more into the nature of the contract, the nature and effect of the breach, and the relationship between the parties.<sup>212</sup> The laws of both countries view willful breaches negatively.<sup>213</sup>

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208. UCL, art. 164 (P.R.C.); see also BING LING, *supra* note 46, at 344–45.

209. UCL, art. 165 (P.R.C.); see BING LING, *supra* note 46, at 344–45. Article 165 differs from CISG, art. 51(2), in that under the UCL if the defaulting party to the contract prejudices the remaining party, both the seller and buyer are entitled to terminate the contract. See *id.* at 345–46. Compare CISG, art. 52, and UCL, art. 165 (P.R.C.).

210. UCL, art. 166 (P.R.C.).

211. See *supra* notes 187–89 and accompanying text.

212. See *supra* notes 191–98 and accompanying text.

213. See *supra* notes 190, 198 and accompanying text.

The discussion of the China Contract Law's treatment of partial performance of obligations and contracts is illustrative here because substantial performance is a common law doctrine designed to prevent forfeiture and intended to allow a party to recover under a contract provided that its performance is substantial. Article 72 of the UCL looks to avoid forfeiture of the contract by having the aggrieved party accept partial performance unless its interests are hurt. And similarly, the provisions in Chapter 9 of the UCL place an importance on the principal rather than the ancillary parts of sales contracts.

## 2. Defenses Excusing Non-Performance

### a. Force Majeure

Under Chinese law, an event of *force majeure* is a justifiable ground for termination of contract. If a party delays in performing his contractual obligations and subsequent to the delay an event of *force majeure* takes place, the party will still be held liable for losses suffered by the other party as a result of the *force majeure*. Under the UCL, the *force majeure* event must be unforeseeable and unavoidable: "any objective circumstance which is unforeseeable, unavoidable and insurmountable."<sup>214</sup> The party invoking the defense bears the burden of proving that the particular event could not be avoided, and that it had taken adequate measures to attempt to prevent the event from happening or losses from being suffered.<sup>215</sup>

A party claiming *force majeure* must give proper notice to the innocent party, and bears the burden of proving the existence of the *force majeure* event.<sup>216</sup> The purpose of notification is to enable the other party to mitigate losses. Similar to the U.S. system, the UCL imposes a duty on the part of the non-defaulting party to mitigate losses in case of default by the other party. The victim of the breach must take "proper measures to prevent enlargement of the loss."<sup>217</sup>

### b. Repudiation—The Other Party's Non-Performance

The UCL, in Article 68, allows a party to suspend its per-

214. UCL, art. 117 (P.R.C.).

215. *Id.* art. 118.

216. *Id.*

217. General Principles of Civil Law, art. 114 (P.R.C.).

formance if it has "conclusive evidence" the other party may or will lose its ability to perform.<sup>218</sup> The UCL represents a break with the FECL by allowing for termination if there is evidence of a clear repudiation by the other side.<sup>219</sup> Article 108 states: "Where one party expressly states or indicates by its conduct that it will not perform its obligations under a contract, the other party may hold it liable for breach of contract before the time of performance."<sup>220</sup>

According to the Pre-1999 Contract Laws, when a breach was caused by the higher authority of a contracting party, the defaulting party was liable for damages.<sup>221</sup> The UCL has abolished that concept. Instead, the UCL provides that even where a breach is caused by a third party, the contracting party concerned is still liable for the breach.<sup>222</sup> Thereafter, however, the innocent party can resolve the matter with the third party that has caused the breach. To replace the *higher authority* with the *third party* is apparently the result of the development of the Chinese economy from a planned to a market economic system. At the same time, it shows that the Chinese law drafters have become more skillful and mature, for third party includes both the higher authority and other persons and entities.

### c. Void Contracts

Under the UCL, contracts can be recognized as void if they are concluded by fraud or duress, signed by agents without authority from principals, violate public policy or other laws and regulations, or if the content is illegal.<sup>223</sup> Fraud is defined as the use of false information to induce the other to enter the contract.<sup>224</sup> Duress occurs when one party coerces the other to sign a contract against his will by threatening or causing harm to the other's property or family members. Sales of illegal drugs are an example of illegal contracts that will be considered void.<sup>225</sup>

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218. UCL, art. 68 (P.R.C.).

219. *Id.* art. 94(2).

220. *Id.* art. 108.

221. BING LING, *supra* note 46, at 401.

222. *See id.*

223. Zhong Jianhua & Yu Guanghua, *China's Uniform Contract Law: Progress and Problems*, 17 UCLA PAC. BASIN L. J. 1, 16-17 (1999).

224. *Id.* at 17.

225. *Id.*

#### D. REMEDIES FOR BREACH OF CONTRACT

Like U.S. law, liability for breach of contract under the UCL serves to enforce the contractual right of the aggrieved party, and to secure its expectation interests.<sup>226</sup> Under the Pre-1999 Contract Laws, liability for breach of contract was designed to *punish* the defaulting party.<sup>227</sup> Today, only non-performance of *mandatory law* will lead to punitive damages.<sup>228</sup> For example, a business operator who commits a fraudulent act may face punitive damages.<sup>229</sup>

Chapter Seven, including Articles 107 through 122 of the UCL, defines the remedies available for breach of contract. Under the UCL, a party facing a breach of contract by the other party has a similar choice to the U.S. system in its election of remedies: it may demand performance or seek remedies such as damages. Article 107 provides that when a party breaches the contract, the party in breach is liable to perform its obligations and to take remedial measures or to compensate the other party for losses. Under the UCL there are two main remedies for breach of contract: compensatory damages or specific performance.<sup>230</sup> Each type of remedy will be discussed in turn.

##### 1. Monetary Damages under the UCL

If there is a breach of contract, the innocent party may seek compensatory damages. If both parties have breached the contract, they share liability.<sup>231</sup> Under the UCL, the liability for breach of contract is defined by the loss suffered by the innocent party.<sup>232</sup> The definition of the amount of damages comes from the GPCL. Compensation is calculated based on the loss caused by non-performance, including lost profits and any expected

226. BING LING, *supra* note 46, at 379. The aim of the remedy of damages, like that of contractual liability, is to place the aggrieved party in as good a position as if the contract had been fully performed. *Id.* at 433; *see also* U.C.C. § 1-106(1).

227. BING LING, *supra* note 46, at 380.

228. *Id.* at 380. The author gives as an example the non-performance of a supplier of defective products. *Id.* at n.5. That supplier may be subject to punitive administrative penalties under the Product Quality Law or criminal penalty under the Criminal Law. *Id.*

229. *Id.* at 445 (noting that the business operator would be liable for damages per the provisions of the Consumer Rights and Interest Protection Law of the People's Republic of China).

230. UCL, art. 107 (P.R.C.).

231. *Id.* art. 120.

232. *Id.* art. 113.

benefits from performance.<sup>233</sup> Moreover, the amount of compensatory damages cannot exceed the loss the breaching party ought to have foreseen at the time the contract was made. Therefore, a party may recover actual damages and consequential damages but not unforeseeable damages.<sup>234</sup>

Article 112 lays out the general damages provisions for the UCL. If a party fails to perform its obligations or if performance does not meet the contract terms, the party has breached the contract and it shall, after performing any obligations or remedial measures, "compensate for losses if the other party suffers from other losses."<sup>235</sup> Losses are assessed on the basis of putting the innocent party in the position they would have been in had the contract been performed.

Article 113 deals with causation of damage and calculation of damages, providing:

The amount of compensation for losses shall be equal to the losses caused by the breach of contract, including the interest receivable after the performance after the contract, provided the compensation does not exceed probable losses caused by the breach of contract which have been foreseen or ought to have been foreseen at the time of formation of the contract.<sup>236</sup>

The causation test relates to the idea of foreseeability, providing that a party suffers a compensable loss where the facts are that, at the time of formation, the breaching party would or ought to have foreseen the loss.<sup>237</sup>

Article 114 allows a court or arbitral tribunal to use the contractually specified method for calculating the parties' damages. Article 114 seems to cover all types of damages.<sup>238</sup> Article 114 also allows the parties to include a liquidated damages clause and/or a penalty clause to try to encourage performance of the contract. If the fine or penalty fixed in the contract is lower or excessively higher than the actual loss, the innocent party may ask the court to revise the sum. If the fine or penalty

233. *Id.*

234. *Id.*

235. *Id.* art. 112.

236. *Id.* art. 113.

237. *Id.*

238. Article 115 examines the use of a deposit. *Id.* art. 115. Pursuant to the Security Law, the deposit is granted to the performing party upon completion of obligation. But if the party paying the deposit fails to perform its obligation, it cannot demand return of the deposit. If the party taking the deposit fails to perform its obligation, it must pay the party paying the deposit double the amount of the deposit. *Id.*

is imposed for late performance, it does not relieve the breaching party of its duty to perform the contract.<sup>239</sup>

Similar to the U.S. system, the UCL imposes a duty on the part of the non-defaulting party to mitigate losses in case of default by the other party.<sup>240</sup> Article 119 addresses the mitigation of damages, providing that the innocent party should adopt adequate measures to prevent the aggravation of loss caused by the breaching party. If the innocent party does not mitigate losses, they are not entitled to claim damages for the aggravated damage caused by their failure to mitigate.

#### a. Liquidated Damages

The UCL permits the parties to agree to liquidated damages in the contract. For instance, parties may, by mutual agreement in their contract, fix an amount as penalty for breach of contract. The parties may agree upon a formula for calculating the amount of liquidated damages as well.<sup>241</sup> The amount of liquidated damages may be adjusted to match the actual damage caused by non-performance.<sup>242</sup>

The liquidated damages clause becomes operational once a party expresses, through communication with another party or its action, its intent not to perform the contract regardless of whether the period for performance has expired. If the penalty amount is less than the loss suffered, including economic loss that is foreseeable at the conclusion of the contract, the party concerned may request the court or arbitration tribunal to raise the amount so that all losses can be covered. Penalties may also be agreed upon for delayed performance. This is new in Chinese contract law. Under such circumstances, if any party fails to perform the contract in time, the breaching party must pay the penalty to the other party. At the same time, he must also perform the contract.<sup>243</sup>

The amount of liquidated damages may be fixed in the contract, but is also occasionally regulated by administrative regulations or law.<sup>244</sup> If the clause regarding liquidated damages is

239. Article 116 provides that an innocent party may elect use of a penalty clause or a deposit provision, but not both. *Id.* art. 116.

240. *Id.* art. 119.

241. *Id.* art. 114.

242. *Id.*

243. Zhong Jianhua & Yu Guanghua, *supra* note 223, at 50.

244. *Id.* at 24. An example of such a regulation is the regulation of contracts for the sale of industrial and mineral products. In article 35 of the regulation, the ad-

too excessive and does not represent actual damages, the party having to pay may bring a petition to the People's Courts or an arbitral body to reform the liquidated damages provision so that the provision conforms more closely to actual damages.<sup>245</sup>

#### b. Payment of Deposit

A contract may also stipulate payment of deposit as guarantee. Where a deposit is made as a guarantee for performance, the party having made the deposit will lose the deposit if they fail to perform their contractual obligations. If the other party fails to perform, the breaching party must pay two times the deposit.<sup>246</sup>

It should be noted that where the contract includes provisions for both the liquidated damages clause and the deposit payment, in the case of a breach of contract, the innocent party may elect the liquidated damages remedy or the deposit provision. Moreover, if the non-performance of one party is the result of third party actions, the non-performing party still bears the liability for its breach of contract and must separately seek compensation from the third party.<sup>247</sup>

### 2. *Specific Performance under the UCL*

Traditionally, Chinese law has emphasized the importance of specific performance. When China's economy was developing, specific performance was a means for ensuring there would be economic progress and development. The recent changes in China and its hopes to move towards a more market-oriented society have resulted in a lesser dependence on specific performance. The UCL no longer compels specific performance, as was the case under the FECL and ECL, but the innocent party still has an option to make a request for specific performance.<sup>248</sup>

The rationale for retaining the traditional remedy of specific performance is to preserve the unique value of the contract's subject matter and to retain this traditional part of Chinese law.

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ministrative agency has set the amount of liquidated damages between one and five percent for general products and ten and thirty percent for specialized products. *Id.*

245. UCL, art. 114 (P.R.C.); John Gregory, *Uniform Contract Law of the People's Republic of China: First Comparative Look*, 12 FLA. J. INT'L L. 467, 482 (2000).

246. Security Law, § 6.2.03 (P.R.C.).

247. UCL, art. 121 (P.R.C.).

248. *Id.* art. 110.

Articles 109 through 111 deal with specific performance.<sup>249</sup> Article 110 is the main article regarding specific performance. Article 110 provides that if a party does not perform the obligation, which is not a financial obligation, or if the party has not performed the obligation according to the contract, the other party may request the breaching party to perform the obligation (specific performance). Courts will not order specific performance, however, "if performance is impossible in law or fact, the subject matter of the obligation is not suited to specific performance, the cost of performance would be excessively high, or the obligee failed to demand performance within a reasonable time."<sup>250</sup> The language of Article 110 seems to imply that specific performance is still available as the primary remedy at the request of an innocent party.

Article 111 provides that, in the absence of an agreement on quality, the innocent party may request the breaching party to repair, substitute, or remake the subject of the contract (including goods). Alternatively, the innocent party may return the non-conforming goods to the breaching party, or request a reduction in the price or reward for the non-conforming goods. The approach of Article 111 encourages parties to cure defects in non-conforming goods. It differs from Article 110 specific performance because it encourages performance but does not compel parties to act.

Moreover, Article 111 only applies to disputes over quality that are not stipulated by the contract or fixed by the agreement of the parties, the terms of contract, or the relevant commercial usage. The right of the innocent party to seek specific performance depends on the nature of the subject or the goods involved and the extent of damages to them. Article 111 also allows limited damages as a remedy if there is a problem with the quality not fulfilling the terms of the contract for goods or services. Damages are calculated as applied for in the contract. If there is no provision for liquidated damages, one may consult Article 61, or, if neither of these provisions are applicable, the innocent party may request that the other party take remedial action, including substitution of goods or a reduced contract price.

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249. Article 109 refers to situations in which a party fails to pay money or other rewards in compliance with the contract. Then the innocent party may request payment. If the breaching party refuses to comply with the innocent party's request, the court may compel the breaching party to pay the amount. *Id.* art. 109.

250. UCL, art. 110 (P.R.C.).



### *3. Similarities and Differences between U.S. and Chinese Contract Law Remedies*

#### a. Differing Philosophies of Contract Performance

There is a fundamental difference in civil and common law systems regarding remedies for breach of contract. Civil law systems emphasize good faith performance and create systems friendlier to a specific performance remedy while the common law believes a party purchases performance or damages when signing a contract. The UCL walks a fine line between the civil law tradition and common law tradition by offering monetary and compensatory damages as a main remedy. In the past, the Chinese ECL emphasized that specific performance was a primary remedy and compensatory damages only a secondary remedy. Moreover, the ECL stated that a party could seek both specific performance and money damages.

The changes in the UCL, heralding a middle way between civil law and common law, are a positive development in China. Part of the motivation for the change is a general thrust towards a more market-oriented economy rather than a socialist economy. In addition, while the UCL remains more protective of people's interests—some would say paternalistic—more autonomy is offered to parties in contracting and even individuals have the ability to contract under the new law.

Moreover, it should be noted that, while it is rare, specific performance is an accepted remedy in common law. So both the U.S. system, by allowing courts more discretion in granting specific performance, and the Chinese system, in moving from specific performance (but retaining it as an option) and moving towards monetary damages, seem to be meeting in the middle.

It should also be noted that the emphasis on good faith is different in the civil law context than the common law context. This difference relates to the paternalistic factor in that the UCL provides damages against parties who, during the negotiation phase, do not comport with good faith requirements as listed in the UCL. Similar remedies are not available under U.S. contract law. This is partly due to the assumptions in U.S. contract law of an arms length negotiation, with sophisticated parties. Especially in the business context, this assumption is strong.

## b. Types of Damages

The UCL represents a step towards a common law system, in terms of the divide between monetary/specific remedies, as the scale is tipping towards favoring monetary and compensatory damages. The scope of the UCL is slightly broader, however, in that the parties have the opportunity to recover both actual damages and consequential damages. Consequential damages have been defined as “benefits which could have been obtained after performance of the contract but such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen” at formation of the “contract as a possible consequences of the breach of contract.”<sup>251</sup> The definition of “possible consequences” of the breach of contract differs from the U.S. common law standard, in that it is a more permissive standard than the “probable result” language of the Restatement (Second).<sup>252</sup> Therefore, from the textual differences between the UCL and Restatement (Second) languages, it seems the reach of the consequential damages is greater under Chinese law than U.S. law. The future importance of this difference will depend partly on how the tribunal adjudicating the matter defines “possible.”

The damage provisions in the UCL are also similar to U.S. law in that both systems impose a duty on the non-breaching party to mitigate losses. In addition, the *Hadley* principle of foreseeability as one prerequisite to recovering damages is similar in both systems, though it is acknowledged that the flexibility of the consequential damages provision in the UCL makes the scope of damages recoverable broader in China than in the United States.<sup>253</sup>

Also, the UCL adopts the perspective that the purpose of monetary damages is to put the party in the position they would have been in had there been full performance. This is very similar to the expectation measure of damages under U.S. contract law. Moreover, even the liquidated damages clauses permitted by the UCL may be revised by a court if it appears the plaintiff would receive an inordinately high award. This is similar to the impetus in U.S. law to prevent a plaintiff from gaining a windfall through litigation rather than performance of the contract.<sup>254</sup>

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251. *Id.* art. 113.

252. RESTATEMENT (SECOND) OF CONTRACTS § 351(1) (1981).

253. *See supra* notes 251–252 and accompanying text.

254. Finally, Article 110 of the UCL is similar in terms compelling specific per-

### c. Liquidated Damages

Similar to the Chinese provision allowing reform of liquidated damages clauses, the U.C.C. has a provision providing that liquidated damages should reflect foreseeable and anticipated damages.<sup>255</sup> The U.C.C. language states that liquidated damages should be set "at an amount which is reasonable in light of the anticipated or actual harm." By contrast the UCL states expressly that if the liquidated damages clause does not accurately reflect actual damages, there will be a readjustment. In other words, under Chinese law the readjustment is *mandatory*, whereas the U.C.C. approach is *permissive*.

### d. Specific Performance

The main difference between the UCL and the pre-existing Chinese contract law is the movement away from specific performance. The fact that specific performance is no longer compelled but is a discretionary remedy available at the court's election makes the Chinese system much more similar to the U.S. system. In the U.S. contract law system, claimants retain the right to request specific performance. While it is doubtful their request will be granted outside of real estate transactions, it remains a valid request. Moreover, the changes in the U.C.C. may herald an increased role for specific performance as courts are granted greater discretion.

It should be noted, however, that in China there continues to be a more robust tradition of specific performance, so it is possible that claims, even though they are at the discretion of the court, are more likely to be enforced in China than in the United States.

## III. LIMITATIONS IN A COMPARATIVE CONTRACT LAW ANALYSIS

The preceding discussion has highlighted both similarities

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formance, exempting circumstances where the resale of goods is impossible. UCL, art. 110 (P.R.C.). Under U.C.C. § 2-709, action for the price is now generally limited in those cases where resale of goods is impracticable unless the buyer has accepted the goods or where goods have been destroyed after risk of loss has transferred to the buyer.

255. U.C.C. § 2-718 (1978). The U.C.C. language states that liquidated damages should be set "at an amount which is reasonable in light of the anticipated or actual harm." *Id.*

and differences between the UCL and the contract law applicable generally in the United States. The following discussion recognizes that even those limited comparisons have their frailty. There are many pitfalls of which to be wary, only the most glaring of which are briefly addressed here.

Businesses and investors are attracted to projects in which risk can be both mitigated and precisely calculated. Alas, China's legal system simply cannot offer the certainty most investors require. While China's legal system is maturing rapidly, it would be difficult to imagine greater flux in a professional community. Its stability suffers from both cultural and demographic problems.

#### A. CHINESE CULTURE

While the UCL mirrors Western law in many important ways,<sup>256</sup> it runs contrary to traditions which have evolved in China over millennia.<sup>257</sup> Law Professor Teemu Ruskola asserts that Chinese law provides a paradigmatic example of "law without law," a normative order that falls radically short of 'real' law, the kind that exists under the configuration we often call the 'rule of law.'<sup>258</sup> Historically, political understanding in China has been based upon the ideal of the rule of men, *ren-zhi*, rather than the rule of law that Westerners are accustomed to. Under the rule of men, those in power derive their authority to govern from their superior virtue—Confucian virtue in traditional China and Communist virtue in social China.<sup>259</sup> While Western legal philosophy is based largely on ideals of universal law applied equally to all members of society, Chinese philosophy of law, and life, is premised on obedience to superiors within a hierarchy.<sup>260</sup> The influence of Chinese culture, especially Confucianism, Taoism, and China's Communist history, and the

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256. It should be noted that the basic similarities present yet another danger which can be largely mitigated by retaining competent local counsel; foreign investors should be cautious not to move forward with a contract assuming any similarities. Beyond the obvious potential for disparate application of similar sounding principles and subtle but often important differences in the details, Chinese is a difficult language to translate to English; many Western terms of art simply do not have Chinese counterparts, and vice versa.

257. For an excellent overview of how cultural tradition in China effects current contract law, see Pattison & Herron, *supra* note 8.

258. Teema Ruskola, *Law Without Law, Or is "Chinese Law" an Oxymoron?*, 11 WM. & MARY BILL OF RTS. J. 655, 655 (2003).

259. *Id.* at 659–60.

260. *Id.* at 661.

currently frail structure of the Chinese legal system are important factors in the slow movement of improving enforcement of Chinese laws.

### 1. *Philosophy*

The philosophy of Confucius has been the official state philosophy of China since the second century, having a profound effect on the shaping of Chinese law and society.<sup>261</sup> Confucius promoted virtues of ethics which emphasized benevolence, goodness, and humaneness, relying on principals of duty, loyalty, honor, filial piety, kindness, sincerity, and respect for age and seniority.<sup>262</sup> Hierarchy and individual roles within society are key to Confucian thinking. Confucius believed that when all people remain within their established roles, the rule of man will be sufficient.<sup>263</sup> The importance of the role of each individual is still seen today in the importance of interpersonal relationships in business dealings.

Lao Tzu, the author of the Tao Te Chiang, the foundation of Taoism, has also had a profound effect on Chinese culture and philosophy throughout history. Taoism stresses an individual search for spiritual self-fulfillment through a rejection of false desires.<sup>264</sup> Taoism, by its nature of seeking self-fulfillment and following the Way, rejects the need for written law. Only when one loses the Way does one lose integrity, humaneness, righteousness, and etiquette; and only then does disorder cause the need for law to arise.<sup>265</sup> Thus, turning to the courts and the enforcement of written law may be viewed as a weakness and disorder, rather than adherence to the Way without the assistance of laws.

A third major influence on Chinese philosophy and culture is Sun Tzu, the author of the Art of War. The Art of War teaches that the way to accomplish more is to do the least, to use psychological tools to outwit and deceive opponents in order to turn weakness into strength and achieve the desired outcome without fighting.<sup>266</sup> Additionally, "adaptation to a changing environment with speed, surprise and flexibility is stressed."<sup>267</sup>

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261. Pattison & Herron, *supra* note 8, at 478.

262. *Id.* at 478.

263. *Id.*

264. *Id.* at 480.

265. *Id.* at 481.

266. *Id.* at 482.

267. *Id.*

Not only is this philosophy still widely applied to business transactions today, making it essential that U.S. companies understand the philosophy in order to effectively conduct business, Sun Tzu's philosophy can also be seen in the application of laws. Rather than going to court and using the laws to fight to achieve their goals, Chinese companies would rather use strategy. Thus, courts in China are simply not viewed as a means to win a business battle as they are in the United States.

## 2. *Communism*

Communism also had a lasting effect on the philosophy and culture of China. For many years, the focus in China was on the community as a whole; everyone worked for everyone, no one had personal property and, therefore, no one had a reason to protect personal property. As a result of Communism and the influence of the above philosophies, the Chinese continue to focus more on group actions and roles than on individual achievement or personal ownership.<sup>268</sup> The idea of common good persists even in contract formation, and contractual relationships often must be preceded by some other kind of group or societal relationship.<sup>269</sup> After China adopted the Soviet doctrine and the Communist Party, there was no place for an autonomous legal system free from politics and policies.<sup>270</sup> Party leaders took over the role originally assigned to the law.<sup>271</sup> Although China now has a constitution and a theoretically independent legal system, how to reconcile the entrenched Soviet-style system with this reformed law-based system remains in question.<sup>272</sup>

## 3. *Personal Relationships/Business Relationships*

Many Chinese businesses are formed around family, with family being the main focus, rather than the business.<sup>273</sup> Societal roles and, more importantly, familial roles were established largely as a consequence of Confucian teachings extended to the business world. Social networks are of the utmost importance

268. *Id.* at 486.

269. *Id.*

270. Amanda Reid, *Enforcement of Intellectual Property Rights in Developing Countries: China as a Case Study*, 13 DEPAUL-LCA J. ART & ENT. L. & POLY 63, 88 (2003).

271. *Id.* at 88-89.

272. *Id.* at 89.

273. Pattison & Herron, *supra* note 8, at 483.

as the Confucian state is composed not of individuals but of interconnections and interdependencies.<sup>274</sup> Everyone is expected to have a role, to know their role, and to work within the social network in order to make the business function effectively. If individuals act within their roles, rules and laws are of little consequence as leaders and elders make the important decisions, and others carry out those decisions without question as they are taught to always respect superiors and elders, and their decisions.

This idea of family extends beyond traditional blood-related families to personal relationships, or *guanxi*. *Guanxi* remains central in interpersonal, bureaucratic, and commercial dealings in China,<sup>275</sup> and without *guanxi* there is little hope of successfully entering into Chinese business.<sup>276</sup> Often viewed by outsiders, including American business investors, as a corrupted system of cronyism and bribery, *guanxi* suggests relationships that include mutual obligation, reciprocity, goodwill, and personal affection.<sup>277</sup> Building *guanxi* is considered essential to any respectable Chinese business person and a great deal of time, energy, and money is often committed to returning favors and creating obligations for others to return favors. People who have *guanxi* can accomplish just about anything, whether or not it is against the official rules.<sup>278</sup> The favoritism shown to local businesses is also often a product of the concept of *guanxi*.<sup>279</sup>

There are three levels of *guanxi*: 1) the highest, inner circle for family members, 2) non-family members who have a significant connection based on trust or shared experience, and 3) strangers who are not known and not trusted.<sup>280</sup> The relationship between business people then, and the role that they play in this hierarchy, remains an important aspect of business and law in China. The rule of law is still subject to the rule of man and personal relationships may have a profound effect on the actions of government officials and judges in enforcing contractual rights.

Confucianism, with its rigid social hierarchy and the con-

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274. *Id.*

275. Robert Bejesky, *Investing In The Dragon: Managing The Patent Versus Trade Secret Protection Decision For The Multinational Corporation In China*, 11 TULSA J. COMP. & INT'L L. 437, 450 (2004).

276. Pattison & Herron, *supra* note 8, at 484.

277. *Id.*

278. *Id.*

279. Lee, *supra* note 11, at 985.

280. Pattison & Herron, *supra* note 8, at 485.

cept of *guanxi* networking, which includes a heightened loyalty to immediate family, affects the business and contract climate in ways Westerners do not expect. It creates an aversion to conflict and litigation.<sup>281</sup> This changes the structure of negotiations; post-ratification changes are expected and encouraged if it helps avoid a breach and results in a fulfilled contract. The structure of contract negotiations is further warped by the need for trust in business relationships.<sup>282</sup> Chinese businesses often bypass negotiation entirely.<sup>283</sup> Chinese negotiators may find it difficult to flatly refuse a proposal, and will instead suggest that it is inconvenient or under discussion.<sup>284</sup>

## B. LEGAL STRUCTURE AND LIMITATIONS

Overall, though, the risk inherent with Chinese investment has not been due to a lack of substantive rights and rules, but of having inadequate enforcement of those rights.<sup>285</sup> Top Chinese government officials have even admitted that the judiciary is plagued with problems such as partiality, incompetence, and corruption.<sup>286</sup>

Demographics play a large role in constructing the current chaos of Chinese law in general. While China's size provides demand for the biggest projects and the best technology, the majority of China's population is too poor<sup>287</sup> to support a legal community in the proportion of Western nations. China continues to develop a legal community; in 1979 there were only two law schools and fewer than three thousand lawyers, compared with two hundred law schools and one hundred thousand lawyers in 1999.<sup>288</sup>

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281. *Id.* at 488.

282. *Id.* at 487.

283. Although this is unlikely to happen in the most visible and valuable contracts within a project (Article 270 of the Chinese Contract Law Statute requires that construction project contracts be written), contracts between locals for service or supplies on the ground may not even be written, or the written agreement discarded as merely a starting point.

284. SCOTT D. SELIGMAN, *CHINESE BUSINESS ETIQUETTE: A GUIDE TO PROTOCOL, MANNERS, AND CULTURE IN THE PEOPLE'S REPUBLIC OF CHINA* (2001). This problem is similar in nature to those discussed in note 12.

285. *Id.* at 454.

286. *Id.* at 455.

287. China's per capita GDP is U.S. \$6,200, or 118<sup>th</sup> place in the world. Central Intelligence Agency, "Rank Order—GDP—Per Capita," *THE WORLD FACTBOOK*, <http://www.cia.gov/cia/publications/factbook/rankorder/2004rank.html> (last updated Jan. 10, 2006).

288. Arwen Joyce & Tracey Winfrey, *Taming the Red Dragon: A Realistic As-*



Despite a lack of trained lawyers, China's legal system tries six million cases per year in thousands of different jurisdictions.<sup>289</sup> China is a civil law society, and has little use for precedent. Separation of powers is likewise not a concept put to use in the Chinese government in any way familiar to Westerners, and this gives rise both to judgments overturned by other government branches, appeals brought by those other than parties,<sup>290</sup> and corruption.<sup>251</sup> These factors diminish the predictability so valued by investors. So difficult are these waters to navigate that some scholars advocate taking any steps possible to avoid the system.<sup>292</sup>

### 1. Structural Problems

There are inherent structural problems within the PRC that make the enforceability of Chinese contracts difficult or at least inconsistent. The problems begin with the PRC's legislature and judiciary and continue through to the surprisingly strong independence of local government.

#### a. Legal Interpretation by the Standing Committee

China is generally a civil law system and judicial decisions are not normally precedent setting.<sup>293</sup> The power of legal interpretation is usually vested in the authority that promulgated the law or statute. However, the ultimate authority is with the NPC Standing Committee. As of yet, the Standing Committee has not really exercised its interpretive power and has let the

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*assessment of the ABA's Legal Reform Efforts in China*, 17 GEO. J. LEGAL ETHICS 887, 900 (2004). Even so, this still leaves China with a dearth of experienced lawyers.

289. *Id.*

290. See generally *Binhai Entm't Co., Ltd. of Haikou City, Hainan Province v. Hainan Huaxin Realty Mgmt. Co.*, CHINALAWINFO (find at <http://chinalawinfo.com> (ID: CNLCAS 195)) (Sup. People's Ct., May 16, 2001) (appeal filed by Chinese Procurator or Attorney General rather than by either party).

291. See James H.M. Sprayregen, Jonathan Friedland & Yong Wang, *The Middle Kingdom's Chapter 11?: China's New Bankruptcy Law Comes Into Sight*, 23 AM. BANKR. INST. J. 34, 34 (2005). "Since local governments exert a large influence on the staffing and funding of local courts, the Chinese court system is widely regarded as not independent." *Id.* at n.3.

292. "Chinese courts, while making promising progress, remain a problematic forum and should arguably be the last resort for parties engaged in dispute." Carlos de Vera, *Arbitrating Harmony: "Med-Arb" and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China*, 18 COLUM. J. ASIAN L. 149, 175 (2004).

293. Lee, *supra* note 11, at 986.

Supreme People's Court do so. This leads to enforcement problems when the interpretation by the authorities is unclear or there has not been an interpretation since the courts are not allowed to interpret the law and the case law is not precedential.

#### b. Judiciary Problems

The nascence of Chinese contract law has led to a shortfall in the quantity of qualified judges. That shortfall combined with the precedent issue discussed previously, the influence of political parties, the vagueness in language of the laws and statutes, the conflicts in law between international treaties and local laws, and the ability of the higher courts to find new facts all lead to a judicial system that is ineffective at delivering consistent enforcement of Chinese contracts.

#### c. Enforcement Problems by Local Government

There is a growing decentralization of government in China. Although the national law is the controlling law, local governments are often unwilling or unable to enforce laws promulgated by the central government because of issues like local protectionism and ignorance of the national law.<sup>294</sup> "Structurally, local legislation usually includes only a general statement noting that its formation is in accordance with relevant laws."<sup>295</sup> Statements like this are only a hint of the local favoritism and protectionism that is exercised. In poorer areas, the provinces often do not have the financial resources to purchase books that state the new laws and regulations.<sup>296</sup> In some provinces, the UCL was not even in effect until China joined the WTO. Even when local governments have access to national laws and regulations, vagueness in the language of the laws and the lack of interpretation of the law by the NPC or the legislators continue to leave governments confused.<sup>297</sup>

The disconnect between central government and local governments causes uncertainty in contracts and is also the main source of China's inability to enforce international treaty obligations.<sup>298</sup> There are strides being made to close the gap, but non-enforcement often is tied to large financial gains for local busi-

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294. *See id.* at 984-85.

295. *Id.* at 985.

296. *Id.* at 983.

297. *Id.* at 983-84.

298. *See id.* at 984.

nesses, resulting in corruption.<sup>299</sup>

d. Vagueness in Language

“One notable characteristic of Chinese laws is the vagueness inherent in the wording.”<sup>300</sup> For example, Article 85 of the GPCL simply states that a contract is an agreement used for establishing, changing, or terminating a civil relationship between parties. In Chinese contract law there are concepts like reasonableness, fair dealing, and good faith that might seem familiar to foreigners, but the terms are not defined in Chinese jurisprudence.<sup>301</sup> Although vagueness may seem to be a terrible thing to have in contract law for Americans, it also serves a purpose that is foreign to us: vagueness in the law gives judges the power and latitude to construe laws in ways that serve the public interest. The Chinese courts seem to work more like courts of equity and try to ultimately deliver fairness. The inherent problem with vagueness is that it leads to inconsistency and may serve as a vehicle for corruption.

2. *Consistency Problems*

The goal of any legal system is to have harmonization and uniformity in its laws. Part of the goal of having written laws is so that people have similar expectations and understanding; a basic set of rules by which to play the game. China, like other countries, struggles to make its laws consistent with international laws and even some of its own other domestic laws. With foreign trade becoming an increasingly important part of the Chinese economy, the Chinese government must work to harmonize its domestic laws and regulations, and keep its contract laws in uniformity with foreign laws. When these are out of synchronization, ensuring the enforcement of contracts becomes difficult.

a. International Law Conflicts

As discussed earlier, China has a reputation for under-enforcing international treaties because of the enforcement issues it has at the local government level. Furthermore, China

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299. *Id.* at 985–86.

300. *Id.* at 980–81.

301. *Id.* at 981.

has inconsistencies between its own domestic laws and international treaties. For example, in 1988, China joined and began to enforce CISG.<sup>302</sup> When China joined, it made two reservations: Article 95<sup>303</sup> and Article 96.<sup>304</sup> The Article 96 reservation essentially means that China will not enforce oral contracts. However, since the promulgation of the UCL, the formal requirements of Chinese contracts have been relaxed.<sup>305</sup> Technically, China does recognize oral contracts with foreigners even though it has made the Article 96 reservation.<sup>306</sup> In addition, even though China is a party to the U.N. Convention on the Recognition and Enforcement of Foreign Arbitration Awards of 1958 (New York Convention),<sup>307</sup> other issues such as the local government enforcement issues make these types of treaties moot in those instances.

Another consideration is the law of the foreign party. In *Kashani v. Tsann Kuen China Enterprise Co., Ltd.*, there was an agreement between a U.S. citizen and a Chinese corporation regarding the production of computers in Iran.<sup>308</sup> The U.S. court found that the agreement was not enforceable because the contract violated U.S. laws, even though the agreement was perfectly legal in China and Iran and the defendant was the Chinese corporation. Simply because a U.S. citizen was a party to the agreement the contract was unenforceable.

#### b. Domestic Laws and Regulation Conflict

Domestic inconsistencies also lead to issues with enforcing contracts. Going back to the oral contracts example, although Article 10 of the UCL allows for oral contracts, written contracts may be required by Chinese customs and are required for contracts involving intellectual property, taxation, import licenses, commodity inspection, foreign exchange control, etc.<sup>309</sup> Do these

302. Xiaolin Wang & Camilla Baasch Andersen, *The Chinese Declaration Against Oral Contracts Under the CISG*, 8 VINDOBANA J. OF INT'L COMM. LAW & ARB. 145, 146 (2004).

303. Many countries have made the Article 95 reservation to Article 1.1(b), including the United States.

304. Xiaolin Wang & Andersen, *supra* note 302, at 146.

305. See generally *id.* for an in-depth discussion of the issue.

306. UCL, art. 10 (P.R.C.).

307. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3.

308. *Kashani v. Tsann Kuen China Enter. Co., Ltd.*, 13 Cal. Rptr. 3d 174 (Cal. Ct. App. 2004).

309. Xiaolin Wang & Andersen, *supra* note 302, at 155.

issues then make an oral contract moot in these instances? Is this a *force majeure* issue? Who bears the risk of the loss because the contract was not written? Clearly such issues create problems in the harmonization of laws, and those entering into contracts in China need to be wary of the pitfalls entailed with the enforcement of contracts.

### 3. *Political and Social Problems*

The political and social climate in China presents another area that makes the consistent enforcement of contracts difficult. Although China has moved towards a rule of law system, public policy still plays an important role. Public policy is a consideration even when U.S. courts enforce contracts, but it is a larger factor in China. The role of political parties is very evident in China and must be considered in an analysis of contract enforcement. Also, the looming threat of corruption is a barrier to the consistent enforcement of contracts.

#### a. Public Policy

Public policy plays a very important role in Chinese law. Given the Communist history of China, Chinese courts work more like a court of equity rather than a court of law in an effort to promote fairness. For example, the courts do not follow the American rule regarding litigation costs and often require the loser to bear the costs of litigation. Another example is the purposeful vagueness in the language of laws and statutes which accommodates this principle. Fairness may trump any written laws in the UCL or GPCL.

#### b. Communist Party

Never underestimate the power of the Communist Party in China. It has the power to influence and thus appeal cases to higher courts and the power to overturn them.<sup>310</sup> Consider the fact that the NPC has the power to overturn court decisions.<sup>311</sup>

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310. See Peter K. Yu, *The Harmonization Game: What Basketball Can Teach About Intellectual Property and International Trade*, 26 *FORDHAM INT'L L.J.* 218, 239-40 (2003) (citing the intertwined relationship between the judicial branch and the Communist Party as a reason for courts' ineffectiveness at settling intellectual property disputes); KUI HUA WANG, *CHINESE COMMERCIAL LAW* 44-46 (2000); Lee, *supra* note 11, at 979-83.

311. See Wilke English & Chin Xau, *Franchising in China: A 1994 Look at KFC and McDonald's*, in *INTERNATIONAL FRANCHISING IN EMERGING MARKETS: CHINA*,

In addition, given the importance of rank in the structure of the Chinese government, the Party's secretary general is at the same level as the president of the PRC.<sup>312</sup> The importance of the Communist Party is clearly also an impairment to the consistent enforcement of contractual rights.

### c. Corruption

Corruption is a problem everywhere, but it should be given special attention in China, not because the Chinese are more corrupt, but because the Chinese legal system creates opportunities for corruption. The disconnect between the central and local governments, the vagueness of the language of the laws, and the latitude that is given to the courts to promote fairness all provide avenues for corruption. Enforcement of a contract may hinge on *guanxi*.<sup>313</sup>

Interpersonal relationships pose yet another barrier, though they may not be properly categorized as corruption. This is often referred to as the "good old boy" network in the United States and the "old boy" network in the United Kingdom. For example, in *Beijing Metal & Mineral Import & Export Co. Ltd. v. China Metal & Mineral Import & Export Co. Ltd.*, the statute of limitations was an issue.<sup>314</sup> The plaintiff in this case did not file an action against the defendant company immediately because of the personal ties between the plaintiff's executives and defendant's executives.

## CONCLUSION

China is a country, a culture, an economy, and a legal system in transition. While convergence between China's contract law as written, embodied primarily in the UCL, and that of Western economic and legal systems has taken place, there remain variations in both coverage and emphasis. Moreover, it remains unclear how Chinese contract law on the books will translate to the law as applied or enforced. The multiplicity of judicial forums, the variation in abilities of judicial decision

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INDIA, AND OTHER ASIAN COUNTRIES 37, 43 (Ilan Alon & Dianne H.B. Welsh eds., 2002).

312. Xiaolin Wang & Andersen, *supra* note 302, at 155.

313. Lee, *supra* note 11, at 982.

314. *Beijing Metal & Mineral Imp. & Exp. Co. Ltd. v. China Metal & Mineral Imp. & Exp. Co. Ltd.*, CHINALAWINFO (find at <http://chinalawinfo.com> (CNLCAS 65)) (Higher People's Ct. of Beijing Municipality, June 8, 2000).

makers, and the predilection to resolve disputes by means other than litigation all add to the uncertainty in this area. Finally, the *law as observed* depends much more on custom and culture—the law must be recognized and accepted as a part of the fabric of life before it can have any effect on the average citizen or businessperson in China. The clash of cultures will be an evolving process and convergence at the level of practical recognition will take much longer. As noted previously, although Westerners view contract formation (signing) as the culmination of the process, this is just the beginning of the process for the Chinese. Similarly, the process of exploring these differences in approach that marks the current status of contracting in and with China is just beginning as well.