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Contract Law in the People's Republic of China

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NOTES

Contract Law in the People's Republic of China—Rule or Tool: Can the PRC's Foreign Economic Contract Law be Administered According to the Rule of Law?

ABSTRACT

The emergence of the People's Republic of China (PRC) as a market power and the reversion of Hong Kong to PRC sovereignty in 1997 have focused the attention of the international business community on the PRC's willingness to enforce contractual obligations according to the rule of law. Some scholars have questioned whether the rule of law can ever be realized in China without a change in the basic system of governance. This Note attempts to answer that question, at least in the context of the Foreign Economic Contract Law (FECL), the law governing contractual disputes between Sino and foreign enterprises in the PRC.

This Note first discusses the importance of the rule of law in autonomous business transactions and differentiates the rule of law from an instrumentalist perspective of the role of law. The Note then addresses contract law in the PRC, including the traditional reliance on the rule by law, the government's attempt to move towards the rule of law, and the current status of the law governing contracts between Sino and foreign enterprises. The Note describes the characteristics of a society governed by the rule of law. Using these characteristics as a baseline, it assesses the possibility that Sino-foreign contractual disputes in the PRC may be adjudicated according to the rule of law. It includes a description of the obstacles facing the implementation of the rule of law, suggestions for overcoming them, and an

assertion that it may be easier to overcome these obstacles in the limited context of the contract law governing foreign and domestic enterprises. The Note concludes that although the PRC could institute structural changes that would further the goal of achieving the rule of law without altering the current system of government, ultimately the true implementation of the rule of law in the context of the FECL will either be the result of political change or the cause of it.

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I. INTRODUCTION

"Arbitrary Justice: Breach of contract in China becomes test case;"¹

"S&P Warns China That Confidence May Be Hurt by Contract Disputes."²

Despite the size and growth potential of the People's Republic of China (PRC), some international investors are questioning the wisdom of doing business with Chinese companies.³

Highly publicized contractual disputes between Chinese and foreign enterprises have focused attention on the PRC's perceived failure to consistently enforce contractual obligations according to the rule of law.⁴ China has drawn the attention of the international community for two reasons. First, despite perceived problems with contractual enforcement, the PRC represents a large and attractive market for foreign enterprises. China's economy is the most dynamic of any size in the world.⁵ With a

1. Nigel Holloway, *Arbitrary Justice: Breach of Contract in China Becomes Test Case*, FAR E. ECON. REV., July 20, 1995, at 78, available in 1995 WL-FEER 9081137.

2. Erik Guyot, *S&P Warns China That Confidence May Be Hurt by Contract Disputes*, WALL ST. J. EUR., Dec. 15, 1994, at 13, available in 1994 WL-WSJE 3171393.

3. "After rushing to grab a piece of China's vaunted growth potential, companies are emerging with cautionary tales about how not to do business in a place where central government control is unraveling, business law is in its infancy and what Westerners would call corruption is ingrained in the way of life." Gord McLaughlin, *Chinese Proverb: Woe to He Who Tries to Court the Dragon in Its Own Lair*, FIN. POST, Feb. 4, 1995, at 16, available in 1995 WL 4330108.

4. For example, in late 1994, the PRC's government ordered the McDonald's corporation to relocate one of its largest and most profitable restaurants, despite the existence of a long-term lease. Stephen Hutcheon, *China: McDonald's Loses Prime Site In Beijing Plaza*, SYDNEY MORNING HERALD, Mar. 14, 1995, available in LEXIS, World Library, Txtline File. In 1995, Lehman Brothers sued two state-owned Chinese conglomerates in a U.S. federal court alleging that the conglomerates had failed to cover trading losses. *Lehman Bros. Commercial Corp. v. Minmetals, Int'l*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,841, 1995 WL 380119 (S.D.N.Y. June 26, 1995); *Lehman Bros. Commercial Corp. v. China Int'l United Petroleum & Chem. Co.*, No. 94 Civ. 8304 (JFK), 1995 WL 380106 (S.D.N.Y. June 26, 1995).

5. Doak Barnett, *Political Overview*, in REFORM AND DEVELOPMENT IN DENG'S CHINA 1, 5 (Shao-Chuan Leng ed., 1994).

population of 1.1 billion,⁶ an average annual gross domestic product growth rate of seven percent over the last fourteen years,⁷ an abundance of low-cost labor, natural resources and space, and its proximity to other booming markets in East and Southeast Asia,⁸ the PRC is an attractive target for firms seeking to open new markets. For example, from 1979 to 1982, the amount of money committed for investment in China by U.S. companies totaled \$2.81 billion.⁹ By 1995, U.S. investment in China had increased to \$7.471 billion.¹⁰

Second, Hong Kong, a hub for foreign ventures in the Pacific Rim,¹¹ is scheduled to revert to PRC sovereignty in 1997.¹² Hong Kong is one of the most prosperous economies in the world in part because of its commitment to a free market economy and to the application of the rule of law in business practice.¹³ The concern is that when the PRC takes over Hong Kong, Hong Kong's relatively effective legal system will be replaced by one resembling the PRC's.¹⁴ The comments of a U.S. judge in a recent wrongful death case exemplified these fears.¹⁵ Holding that the case could be tried in the United States, the judge noted that "the uncertain future of the Hong Kong legal system, given the island's reversion to Chinese sovereignty in less than two years, counsels heavily in favor of jurisdiction to ensure that the [plaintiffs] have an

6. Gary J. Dernelle, *Direct Foreign Investment and Contractual Relations in the People's Republic of China*, 6 DEPAUL BUS. L.J. 331, 332 (1994).

7. Richard Leshner, *Taiwan: Should Congress Grant Permanent 'Most Favored Nation' Status to China? Yes: Trade Empowers Chinese Citizens of Every Rank and Quickens the March Toward Democracy*, TOPICS - AM. CHAMBER OF COM. IN TAIPEI, Feb. 1, 1997, available in 1997 WL 9277740.

8. Joseph Battat, *Foreign Investment in China in the 90s: Developing Trends*, E. ASIAN EXEC. REP., Aug. 15, 1991 at 11, 14.

9. *Business as Usual*, ROCKY MOUNTAIN NEWS (DENVER), May 11, 1996, at 4B, available in 1996 WL 7568241.

10. *Id.*

11. For example, over 900 U.S. firms currently do business in Hong Kong. Martin C.M. Lee, *Rule of Law: Why China Needs Hong Kong's Legal System*, WALL ST. J., Dec. 28, 1994, at A13, available in 1994 WL-WSJ 2058178. "Hong Kong is [also] China's second-largest trading partner and accounts for about 60 per cent of China's stock of foreign investment." *HK Business "Role Model for China"*, H.K. STANDARD, Dec. 20, 1996, available in 1996 WL 13887312.

12. Lee, *supra* note 11.

13. "[Hong Kong] is an important international financial center, second only to Tokyo in the Pacific region." Anthony Neoh, *Hong Kong's Future: The View of a Hong Kong Lawyer*, 22 CAL. W. INT'L L.J. 309, 310 (1992) (footnotes omitted). It has 76 of the top 100 banks in the world and is among the top 12 traders in the world. *Id.* "[Hong Kong] achieved this prosperity in a milieu of capitalism amidst minimum government intervention and the Rule of Law." *Id.*

14. Senior Chinese officials have frequently threatened to abolish Hong Kong's bill of rights and its common law legal system. *Id.*

15. *Nowak v. Tak How Investment Ltd.*, 899 F. Supp. 25, 34 (D. Mass. 1995), *aff'd*, 94 F.3d 718 (1st. Cir. 1996).

opportunity to obtain redress, if any be appropriate, for the grievous loss they have suffered."¹⁶

The judge's comments reflect the belief of many experts in the United States and Hong Kong that the rule of law will be eroded in Hong Kong after the island reverts to Chinese sovereignty in 1997.¹⁷ Erosion of the rule of law would expose companies in Hong Kong and those that deal with them to the same risk of contractual non-enforcement as that faced by companies currently doing business with or in the PRC.¹⁸ Further, Hong Kong is a major source of free and unrestricted economic information concerning the PRC.¹⁹ Some speculate that this source of information will dry up after reversion, thus increasing the risk of investing in mainland China.²⁰

The adjudication of contractual disputes according to the rule of law is extremely important to the international business community because the PRC is an attractive market and adjudication according to the rule of law significantly increases the predictability of contractual enforcement.²¹ However, because the law traditionally has been viewed from an instrumentalist perspective in the PRC,²² the question has been raised of whether, given the PRC's current system of government, the law can ever be the kind of overlying, guiding principle that makes contractual enforcement predictable. The goal of this Note is to answer this question, at least with respect to the PRC's Foreign Economic Contract Law (FECL), which governs disputes between enterprises of the PRC and foreign businesses.²³

II. THE RULE OF LAW, RULE BY LAW AND CONTRACTS

In the West, a key characteristic of a "civil society" is "autonomous economic organization and transactions."²⁴ The belief that giving individuals the freedom to maximize their own

16. *Id.*

17. Though tort and contract law are not expected to change as quickly as criminal law and police enforcement, change is expected. Henry J. Reske, *Experts Fear Hong Kong Legal System in Peril*, A.B.A. J., Jan. 1996, at 33.

18. Lee, *supra* note 11.

19. "Beijing releases the 'good news,' but the most important economic information—the 'bad news'—comes only from Hong Kong." Martin Lee, *A Message From Hong Kong to Davos*, ASIAN WALL ST. J., Feb. 5, 1997, at 8, available in 1997 WL-WSJA 3796558.

20. *Id.*

21. See *infra* Part II.

22. See *infra* Part III.A.1.

23. See *infra* notes 83 and 85.

24. RONALD C. KEITH, CHINA'S STRUGGLE FOR THE RULE OF LAW 121 (1994).

wealth results in the maximization of society's wealth is a cornerstone of capitalist philosophy.²⁵ As the noted economist John Maynard Keynes stated in his defense of capitalism during the depression of the 1930s, the allocative efficiencies and experimental creativity achieved through autonomous economic organization and transactions are "powerful instrument[s] to better the future."²⁶

The rule of law is a predicate for achieving autonomous economic organization and transactions.²⁷ The rule of law has two basic principles: (1) people should be ruled by the law and obey it, and (2) the law should be such that people will be able to be guided by it.²⁸ Hence, the rule of law assures that individuals know what the law is so they can maximize their own welfare within its confines. It also assures that individuals can pursue this wealth-maximizing autonomy without interference from either other individuals or the state.²⁹ By assuring that the law is applied equally to all, is binding on the state, and prevents arbitrary actions by the state, the rule of law provides the freedom for the members of a "civil society" to order their own economic affairs.³⁰

Unlike the West, where the law embodies universally held ethical norms and is traditionally regarded as absolute,³¹ China has taken an instrumentalist view of the role of law.³² Under the instrumentalist view, law exists not as an embodiment of commonly held ethical norms, but as a tool for advancing the

25. An individual does not "intend[] to promote the public interest . . . he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention." 1 ADAM SMITH, *INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 456 (R.H. Campbell et al. eds., Oxford Univ. Press 1976) (1776). It is not surprising that both *The Wealth of Nations* and the *Declaration of Independence* appeared in the same year. "Political freedom from the tyranny of monarchy was closely related to emancipation of free-market pricing from the interfering hand of state regulation." PAUL A. SAMUELSON, *ECONOMICS* 2 (11th ed. 1980).

26. JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 380 (Harcourt, Brace 1936).

27. Richard Thornburgh, *The Soviet Union and the Rule of Law*, 69 *FOREIGN AFF.* 13, 14 (1995).

28. Eric J. Segall, *Justice Scalia, Critical Legal Studies, and the Rule of Law*, 62 *GEO. WASH. L. REV.* 991, 995 (1994).

29. *Id.*

30. Franz Michael, *Law: A Tool of Power*, in *HUMAN RIGHTS IN THE PEOPLE'S REPUBLIC OF CHINA* 33, 33 (WESTVIEW PRESS 1988).

31. This conception of the rule of law is well anchored in both Western and non-Western societies, including the United States, the nation-states of Europe, and Asian countries such as Japan and China prior to the overthrow of the national government in 1949. *Id.*

32. *Id.* at 35.

goals of the state.³³ The state's policy is the "soul of the law."³⁴ Individual rights are defined by the law,³⁵ as opposed to the law being shaped by natural rights.³⁶ Under the rule of law, because law embodies commonly held ethical norms, legal change occurs only in response to changes in other spheres.³⁷ Under the instrumentalist view, legal change does not occur in response to changes in other spheres, but rather, is frequently used as a means of promoting change elsewhere.³⁸

There is a strong relationship between the rule of law and Western contract law. In the West, it is believed that the objective and predictable enforcement of contracts is desirable because it maximizes the welfare of the parties involved, thus promoting the welfare of society as a whole.³⁹ Individuals enter into contracts because they believe that an exchange will make them each better off.⁴⁰ Where contracts are enforced in an objective and predictable manner, individuals are better able to determine which transactions will be wealth-maximizing and are able to shift the risk of uncertain events in economically efficient ways.⁴¹ On the other hand, where contractual enforcement is subject to changing state policy, wealth-maximizing transfers may be voided by the state or never attempted due to the risk of

33. Joseph Stalin called the law a "weapon." *Id.* According to Communist doctrine, the law is a tool "used by the dictatorship of the proletariat . . . to suppress opposing classes and to transform society into a predestined socialist and communist order." *Id.*

34. BILL BRUGGER & STEPHEN REGLAR, *POLITICS, ECONOMY AND SOCIETY IN CONTEMPORARY CHINA* 180 (1994).

35. *Id.* at 181.

36. "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain *unalienable Rights*." THE DECLARATION OF INDEPENDENCE para. 1 (U.S. 1776) (emphasis added).

37. Professor Feinerman has noted that:

The almost universal experience of Western market economies has been that law evolves following, and in response to, changes in other realms that create conditions for economic development. For instance, economic conditions must be ripe for development to occur, the political climate must be conducive to change, and there must be the requisite cultural or societal belief that change is desirable and possible. For law to be a part of this process, there must be a widespread belief that law matters and that legal changes can and will be enforced at all levels of society. Thus, law is a necessary but not a sufficient condition for meaningful economic change or development.

James V. Feinerman, *Economic and Legal Reform in China, 1978-91*, PROBLEMS OF COMMUNISM, Sept.-Oct. 1991, at 62, 66.

38. *Id.*

39. E. ALLAN FARNSWORTH, *CONTRACTS* 21 (2d ed. 1990).

40. SMITH, *supra* note 25, at 456.

41. *Id.*

contractual non-enforcement.⁴² Further, the resolution of contractual disputes by a legal system that is an impartial mediator of interests is beneficial for society because it establishes rules to resolve future disputes and “encourage[s] socially desirable behavior by future bargainers.”⁴³ Because of the advantages inherent in a system that provides consistent enforcement of contractual obligations according to the rule of law—i.e., welfare maximization and a reduction of risk—the international business community has become increasingly concerned about the perceived risk of contractual non-enforcement in the PRC.⁴⁴ This concern has developed despite economic and legal reforms in the PRC ostensibly designed to make the law governing Sino-foreign contracts more like Western common law.

III. THE CONTRACT LAW OF THE PRC

In the late 1970s, the PRC initiated its “Four Modernizations program” program aimed at modernizing the PRC’s agriculture, industry, defense, science, and technology, thus transforming China into a “powerful, modern, socialist country by the end of this century.”⁴⁵ The primary focus of the economic reforms was to change the economic system⁴⁶ from one that was centrally

42. To be sure, there is some government intrusion in economic transactions in the West. Regulated markets such as securities exchanges, and the proliferation of consumer protection laws are examples of governmental limitations on autonomy in economic transactions. Feinerman, *supra* note 37, at 66.

However, such use of law is entirely consistent with the experience that law develops out of change in other spheres; these laws came about as a governmental response to the rise in economic power of large corporations. Legal change will always affect markets in some way, so there is a continuing synergy between law and economic development—the economy causes the law to evolve, which in turn affects the market, and so on.

Id.

43. ROBERT E. SCOTT & DOUGLAS L. LESLIE, *CONTRACT LAW AND THEORY* 19 (2d ed. 1993).

44. This concern was exemplified in comments made by James Penrose, assistant general counsel for Standard & Poor’s Ratings Group. Through Penrose, Standard & Poor’s warned China that its ability to raise foreign capital could be put at risk by a “pattern of repeated behavior” in which state-owned, Chinese businesses allegedly breached contracts with Western companies. Guyot, *supra* note 2, at 13.

45. COLIN MACKERRAS ET AL., *CHINA SINCE 1978* 63 (1994).

46. *Id.* at 64.

planned to one that was decentralized and market driven.⁴⁷ Towards this end, the PRC instituted a series of changes⁴⁸ with a common characteristic: "the responses in all cases emphasized notions of contract, the legal responsibility of economic actors to perform their agreements, and the value of individual autonomy in setting the terms of economic transactions and relationships."⁴⁹ These reforms mandated that the PRC transform its legal system from one based on an instrumentalist perspective of the role of law into one more closely resembling a legal system governed by the rule of law, at least in the context of the contract law governing economic transactions between Sino and foreign enterprises.

A. *The Modern History of Contract Law in the PRC*

Until recently, contractual relations in the PRC were subject to the government's instrumentalist view of the role of law. The goal of Chinese contract law was to support the government's economic plan rather than to promote the autonomous ordering of economic transactions. However, the PRC's efforts to decentralize the economy and make it market driven would have been undercut by a legal system in which the law had only an instrumentalist role. Consequently, along with economic reforms, the PRC instituted legal reforms which appeared to herald the coming of the rule of law.

1. Pre-Reform Contract Law: The Instrumentalist Approach

Before the economic reforms of the 1970s, contract law was no more necessary to settle disputes in the PRC's planned economy than it would have been to settle disputes between the divisions of a vertically integrated firm. Within China's planned economy, every organization theoretically worked towards the same goal—the achievement of the state's economic objectives. Hence, the PRC functioned like one large, vertically-integrated firm.⁵⁰ Manufacturers and suppliers were part of the same

47. Donald C. Clarke, *Regulation and Its Discontents: Understanding Economic Law in China*, 28 STAN. J. INT'L L. 283, 285-86 (1992).

48. The functions of state government and enterprise management were separated. Enterprise managers were encouraged to attempt to satisfy consumer demand without subsidies for losses and administrative control over the economy has been loosened. Feinerman, *supra* note 37, at 63.

49. Lucie Cheng & Arthur Rosett, *Contract with A Chinese Face: Socially Embedded Factors in the Transformation from Hierarchy to Market, 1978-1989*, 5 J. CHINESE L. 143, 144 (1991).

50. Professor Clarke notes that:

organization. Under this system, administrative orders from the centralized planning body, rather than contract law, governed transactions between parties.⁵¹ Where a centralized plan could not cover all the details of production and allocation of resources, contracts were used to fill in the gaps. However, because contracts were merely a means for achieving the state's plan, the government would not enforce contracts that did not support the plan's goals.⁵² Consequently, economic transactions were subject to the instrumentalist view of the role of law. The goal of Chinese contract law was not to foster mutually beneficial exchanges through the protection of expectancy interests, as U.S. law does,⁵³ but to promote state control and the state's economic plan.

2. Economic Reform

The 1970s were a period of massive upheaval in the PRC. Following the end of the "cultural revolution" and the death of Mao Zedong⁵⁴ a power struggle ensued from which Deng Xiaoping emerged as the PRC's preeminent leader.⁵⁵ Since early in his political career, Deng had been a proponent of "market

Ministries [were] divisions within the firm and enterprises [were] factories. Within such a system, prices [were] merely accounting conventions and consequently "profit" (price received for output minus price paid for inputs) [was] not a good index of efficiency or social utility. Central planners decide[d] what enterprises should produce and then attempt[ed] to ensure, through commands, that the appropriate raw materials, labor, and transportation facilities [were] available to realize the targets.

Clarke, *supra* note 47, at 287.

51. Dernelle, *supra* note 6, at 346. The Provisional Methods on the Signing of Contracts by (State) Organs, State-Run Enterprises, and Cooperatives, China's 1950s counterpart to the U.S. Uniform Commercial Code, was not designed to make it easier for enterprises to enter into mutually beneficial exchanges, but to bring economic activity under government control. Clarke, *supra* note 47, at 308. "All transactions involving continuing obligations had to involve a contract, and the parties then had to submit a copy to the local People's Bank and to various other supervisory bodies. Furthermore, any payments under the contract had to be made through the People's Bank." *Id.*

52. Rather, if a contract did not support an existing plan's goal or if the plan changed such that the contract was no longer consistent with it, the government would insist that the parties re-write the contract in accordance with state policy. Clarke, *supra* note 47, at 309.

53. See FARNSWORTH, *supra* note 39, at 9.

54. Mao Zedong was the Chairman of the Chinese Communist Party from 1943 until his death in 1976, and was the President of the PRC from 1949 to 1959. MACKERRAS, *supra* note 45, at 5.

55. Cheng & Rosett, *supra* note 49, at 171.

socialism,"⁵⁶ which combines a market driven economy with an adherence to socialist principles.⁵⁷ After Deng's rise to power in 1978, the PRC launched a series of reforms consistent with Deng's beliefs.⁵⁸

The linchpin of the PRC's economic reforms was the decentralization of decision-making authority.⁵⁹ The high-level bureaucracy only maintained decision-making authority over key sectors of the economy.⁶⁰ Decisions in other economic sectors were guided by market forces and made by lower level bureaucrats or enterprise management instead of the central government.⁶¹ Freeing enterprises and workers from the

56. Deng held major party and government posts from 1949 until the beginning of the Cultural Revolution in 1966. MACKERRAS, *supra* note 45, at 5. However, during the Cultural Revolution, the goal of which was to transform "the superstructure of Chinese society into a proletarian culture," *id.* at 8, Deng was branded as "the Number 2 person in authority taking the capitalist road," *id.* at 5.

57. Though Deng was more interested in using communism as a tool for achieving economic growth, he was still a devout Marxist-Leninist. *Id.* at 6. In a major speech at a forum on the principles for the Party's theoretical work entitled "Uphold the Four Cardinal Principles," Deng outlined the prerequisites for achieving the four modernizations of economic reform:

1. We must keep to the socialist road.
2. We must uphold the dictatorship of the proletariat.
3. We must uphold the leadership of the communist party.
4. We must uphold Marxism-Leninism and Mao Zedong Thought.

DENG XIAOPING, THE SELECTED WORKS OF DENG XIAOPING 171-72 (1984).

58. Barnett, *supra* note 5, at 1.

59. Clarke, *supra* note 47, at 283-84. The Communiqué of the Third Plenum of the Central Committee of the 11th Communist Party Congress made the following links between economic reform and the shift of decision making authority:

[O]ne of the serious shortcomings in the structure of economic management in our country is the over-concentration of authority, and it is necessary boldly to shift it under guidance from the leadership to lower levels so that the local authorities and industrial and agricultural enterprises will have greater power of decision in management under the guidance of unified state planning; . . . it is necessary to act firmly in line with economic law, attach importance to the role of the law of value, consciously combine ideological and political work with economic methods and give full play to the enthusiasm of cadres and workers for production; it is necessary, under the centralized leadership of the Party, to tackle conscientiously the failure to make a distinction between the Party, the government, and the enterprise, and to put a stop to the substitution of Party for government and the substitution of government for enterprise administration.

Cheng & Rosett, *supra* note 49, at 194 (quoting Communiqué of the Third Plenary Session of the 11th Central Committee of the Communist Party of China, BEIJING REV., Dec. 29, 1978).

60. *Id.*

61. *Id.*

"shackles of state control" was expected to enable them to improve productivity and efficiency.⁶² The PRC expected that a system based on freedom of contract rather than on central planning would increase production because it would provide rewards for producers.⁶³

Along with the shift of decision-making authority to the enterprise level, the PRC implemented a system of rewards for profitable management.⁶⁴ As discussed above, individuals allowed to autonomously enter into economic transactions are able to maximize their own welfare and thus society's welfare.⁶⁵ Consequently, it was hoped that decentralizing decision-making authority and introducing market rewards would improve efficiency and increase production.⁶⁶

Another important goal of the economic reforms was to attract foreign capital and technology.⁶⁷ To achieve the "four modernizations," the PRC commenced an "open door" policy in 1978.⁶⁸ The "open door" policy was implemented in recognition of the need to attract foreign capital, technology, and equipment to modernize the PRC's infrastructure.⁶⁹ Facets of the open door policy included promulgation of several laws concerning foreign investment,⁷⁰ the delineation of special economic zones to provide foreign investors with favorable operating conditions and preferential treatment,⁷¹ and the creation of securities and

62. Clarke, *supra* note 47, at 284.

63. Cheng & Rosett, *supra* note 49, at 181.

64. For example, in the agricultural sector, a "contract responsibility" system was instituted. *Id.* at 184. Decision-making authority over farmland was allocated to household units. *Id.* These units had to contract to the state to deliver a certain basic level of production at a price below the market price. *Id.* However, beyond that basic level of production, the household unit was free to sell any excess goods on the open market at whatever price the market would bear. *Id.*

65. See discussion *supra* Part II.

66. Using a system of market rewards is not antithetical, even to a devout Marxist-Leninist.

According to Marx, socialism is the first stage of communism and it covers a very long historical period in which we must practice the principle 'to each according to his work' and combine the interests of the state, the collective and the individual, for only thus can we arouse people's enthusiasm for labor and develop socialist production.

DENG, *supra* note 57, at 333.

67. Cheng & Rosett, *supra* note 49, at 189.

68. Dernelle, *supra* note 6, at 332.

69. *Id.*

70. John Z. Huang, *An Introduction to Foreign Investment Laws in the People's Republic of China*, 28 J. MARSHALL L. REV. 471, 472-73 (1995).

71. In 1979, the PRC delineated the cities of Shenzhen, Zhuhai, Shantou, and Xiamen as special economic zones. MACKERRAS, *supra* note 45, at 91. In

futures markets to encourage foreign investment.⁷² Instead of distrusting and disdaining foreign investment as they did in the past, "Chinese leaders now view foreign trade and investment as required instruments for the advancement of political, social, and economic goals and necessary for the creation of a strong, modern, industrial China."⁷³

3. The Need For Legal Reform

For the "four modernizations" to succeed, the government of the PRC realized that economic reform would have to be accompanied by legal reform. As Deng noted, "We must use two hands to carry on the four modernizations: grasping construction with one hand and grasping the legal system with the other."⁷⁴ The economic reform also required legal reform for two reasons.

First, the shift from a centralized to a decentralized market was expected to create a growing demand for economic legislation to regulate the relationships between production units.⁷⁵ When the economy operated as one large, vertically integrated firm, there was little need for contract law.⁷⁶ However, for the market to allocate resources, instead of the state's economic plan, a well-developed contract law would be necessary to resolve disputes between enterprise units.⁷⁷

1984, the PRC delineated 14 other cities as open investment areas. *Id.* at 95. "The [special economic zones were] intended to serve as:

1. sources of foreign exchange earnings;
2. devices for technology transfer;
3. devices for managerial skills transfer;
4. a means for allaying the fears of the people of Hong Kong; and
5. laboratories for economic reform.

Id. at 92.

72. *Id.* at 94.

73. Dernelle, *supra* note 6, at 332.

74. Shao-chuan Leng, *Legal Reform in Deng's China*, in REFORM AND DEVELOPMENT IN DENG'S CHINA, *supra* note 5, at 85, 86.

75. *Id.*

76. See discussion *supra* Part III.A.1.

77. Statistics on the number of economic disputes demonstrate just how important contract law would become.

Before 1979 there were no business cases. . . . However, figures from the early 1980s give some idea of just how rapid the growth of this kind of legal case at that time was. Business cases numbered 89,494 between 1980 and 1983, including over 73,000 contract disputes. . . . The number of legal documents handled by notaries [increased] from 2,797,000 in 1985, . . . to 5,149,000 in 1989 and 9,907,000 in 1991, the great majority of them in each year being economic contracts.

Second, one of the major goals of Chinese economic reform is to encourage foreign investment.⁷⁸ The PRC wants to become part of the world economy.⁷⁹ However, to become part of the world economy, the PRC had to offer potential trading partners the familiar security of a legal system governed by the rule of law.⁸⁰ Contract law operated in a legal system subject to the instrumentalist view of the role of law is inherently unpredictable. In such a legal system, the law serves the policies of the state and changes whenever the policies of the state change.⁸¹ The unpredictability of the PRC's contract law discouraged foreign investment and thus impaired the economic reform efforts.⁸² Consequently, legal reform was required not only to implement the PRC's move towards market socialism, but also to encourage foreign investment in support of the "four modernizations."

B. *The Foreign Economic Contract Law*

The institution of economic reforms in the PRC created a need for a change in the system of law governing economic transactions. To encourage foreign investment, the PRC had to create a legal system which gave foreign investors a higher comfort level. Further, the shift in economic control from a centralized planning body to market forces created a more complex economic system which required a more complex legal

MACKERRAS, *supra* note 45, at 144.

78. See discussion *supra* Part III.A.2.

79. For example, the PRC is currently lobbying for membership in the World Trade Organization and for "most favored nation status" as a trading partner with the United States. See Merrill Goozner, *China Vies with Japan as Trade Surplus Champ*, CHI. TRIB., Oct. 27, 1996, at 1. Leshner, *supra* note 7.

80. Cheng & Rosett, *supra* note 49, at 190.

81. Deng Xiaoping, the PRC's leader during the reform movement stated:

Democracy has to be institutionalized and written into law, so as to make sure that institutions and laws do not change whenever the leadership changes, or whenever the leaders change their views. . . . The trouble now is that our legal system is incomplete. . . . Very often, what leaders say is taken as law and anyone who disagrees is called a law-breaker. That kind of law changes whenever a leader's views change. So we must concentrate on enacting criminal and civil codes, procedural laws and other necessary laws.

DENG, *supra* note 57, at 158.

82. HENRY R. ZHENG, CHINA'S CIVIL AND COMMERCIAL LAW 47-48 (1988). "[T]he lack of a reliable regulatory framework became an obstacle to the further development of Sino-foreign commercial relations for both foreign and Chinese businesses." *Id.* at 48.

system. As a result, the PRC promulgated the Foreign Economic Contract Law (FECL) in 1985.⁸³

1. Scope, Principles, and Choice of Law

The first chapter sets out the general provisions of the law, including its scope, guiding principles, and a choice of law provision.⁸⁴ The scope of the FECL encompasses economic contracts between enterprises of the PRC and foreign enterprises.⁸⁵ On the other hand, the Economic Contract Law (ECL), adopted in 1981,⁸⁶ applies only to domestic contracts. Unlike the ECL,⁸⁷ the FECL is modeled after the Anglo-American common law of contracts.⁸⁸

The principles behind the FECL are equality and mutuality of benefit in accordance with international practice, and state sovereignty.⁸⁹ Article 3 provides that “[c]ontracts should be made in conformity with the principles of equality and mutual benefit, and of achieving unanimity through consultations.”⁹⁰ Unlike the

83. Foreign Economic Contract Law of the People's Republic of China, adopted at the Tenth Session of the Standing Committee of the Sixth National People's Congress on Mar. 21, 1985, *reprinted in* 2 STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA § 850321 (University of East Asia Press & Institute of Chinese Law (Publishers) Ltd. 1987) [hereinafter FECL].

84. *Id.* at arts. 3 - 5.

85. “This Law applies to economic or trade contracts . . . but exclusive of international transport contracts, concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises and other economic organizations or individuals.” *Id.* at art. 2.

86. Economic Contract Law of the People's Republic of China, adopted at the Fourth Session of the Fifth National People's Congress on Dec. 13, 1981, *reprinted in* 1 STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA § 811213.1 (University of East Asia Press & Institute of Chinese Law (Publishers) Ltd. 1987) [hereinafter ECL].

87. The ECL is still dominated by the rule of man in that its goal is to support the state's plan. See ZHENG, *supra* note 82, at 50. As noted by ZHENG, Article 7 of the ECL voids contracts violating the state's economic plan. *Id.* at 52; ECL, *supra* note 86. Under Article 27, a change in the state's plan provides a legitimate ground for terminating or modifying a contract. ECL, *supra* note 86. In contrast, the ECL mandated that the FECL be formulated separately from the ECL with reference to the ECL and international practices. ECL, *supra* note 86, at art. 55.

88. Philip J. Wilson, *The Legal Structure Governing Technology Transfers and Joint Ventures with the People's Republic of China*, 3 INT'L TAX & BUS. LAW. 1, 15 (1985).

89. Zang Yuejiao, *A Brief Introduction to Recent Laws and Regulations Concerning the Absorption of Foreign Direct Investment in the People's Republic of China*, in CHINESE ECONOMIC LAW AND SELECTED COMPARISONS FROM THE PACIFIC RIM 3, 10 (Zhang Lixing et al. eds., 1988).

90. FECL, *supra* note 83, at art. 3.

ECL, parity of consideration is not required under the FECL.⁹¹ This places the FECL closer to the concept of freedom of contract found in Western contract law.⁹² In the West, only bargained-for consideration is required to form a contract, not equal beneficial consideration.⁹³

Articles 4 and 9 of Chapter I express the principle of sovereignty embodied in the FECL. Article 4 mandates that "[c]ontracts must be made in accordance with the law of the People's Republic of China and should not be prejudicial to the public interests of society of the People's Republic of China."⁹⁴ Further, Article 9 states that "[c]ontracts that violate . . . the public interest of the People's Republic of China are invalid."⁹⁵ Though the concept of voiding contracts that are against public policy is found in Western contract law,⁹⁶ some scholars fear that the "public interest" may be interpreted more expansively in the PRC than it is in the West, implicating the instrumentalist view of the law.⁹⁷ Hence, the principles of the FECL are somewhat at odds because the use of the law as an instrument for social change is incompatible with the freedom of contract.⁹⁸

For the first time in Chinese law, the FECL contains a provision stipulating the principles of choice of law.⁹⁹ Article 5 states the following:

The parties . . . may choose the law applicable to the settlement of disputes arising over the contract. In the absence of such a choice . . . , the law of the country which has the closest connection with the contract applies. In case no relevant provision is stipulated in

91. The Economic Contract Law requires that contracts be based on the principle of compensation of equal value. ECL, *supra* note 86, at art. 5.

92. Dernelle, *supra* note 6, at 349.

93. See *Hamer v. Sidway*, 27 N.E. 256, 259 (1891) (holding that the forbearance from engaging in the vices of drinking, smoking, swearing, and gambling was sufficient consideration to support a contract obligating the other party to pay \$5,000, even if the other party was not benefited thereby).

94. FECL, *supra* note 83, at art. 4.

95. *Id.* at art. 9.

96. For example, contracts that obligate a person to commit an illegal act or to violate a fiduciary duty have been found void as against public policy. FARNSWORTH, *supra* note 39, at § 5.2, nn. 13, 14.

97. Given its socialist ideology, its developing economic structure, and its unique history and culture, U.S. investors cannot assume that China's public interest will be defined in the same way that it is in the United States. In fact, as the discussion of political risks suggests, the more reasonable assumption is that it will be defined differently than it would be in a capitalist industrialized Western society.

Chew, *supra* note 55, at 655.

98. See *supra* Part II.

99. Yuejiao, *supra* note 89, at 11.

the law of the People's Republic of China. international practice may apply.¹⁰⁰

Though this provision may provide a certain comfort level to foreign enterprises, it is not clear whether it allows a choice of law as to the formation of the contract or a choice of law as to resolving contractual disputes.¹⁰¹ Consequently, parties need to be aware of the requirements of the FECL, even if they have chosen another nation's law to govern the contract.¹⁰²

2. Formation and Liability for Breach

Chapters II and III of the FECL address the formation of contracts and the liability for breach of contract. Contracts are created when the contractual terms are agreed upon in writing and signed by both parties.¹⁰³ Contracts made under fraud or duress are void.¹⁰⁴ Chapter II contains some provisions which emphasize the state plan over freedom of contract. For example, contracts of joint ventures involving Chinese and foreign capital, joint natural resource explorations, or technology transfers require government approval before they can be established.¹⁰⁵

In contrast, Chapter III's provisions concerning liability for breach of contract seem to contain a subtle nod to the Western ideal that contract law should serve to maximize the welfare of society through the autonomous organization of economic transactions. In breach of contract cases, the ECL entitles the injured party to specific performance to insure that a breaching party does not interfere with the state's plan.¹⁰⁶ The requirement of specific performance in all instances runs counter to Western contract law, which recognizes the concept of "efficient breach."¹⁰⁷ In contrast to the ECL, the FECL entitles the

100. FECL, *supra* note 83, at art. 5.

101. [The FECL] appears to give contracting parties broad power in the choice of law. Some members of the Chinese legal community read this provision to permit the selection of law to be applied in the formation and performance of the contract. A more literal reading of this provision, however, indicates merely that the contracting parties are free to choose the procedural law to be applied in resolving disputes. Dernelle, *supra* note 6, at 351.

102. *Id.*

103. FECL, *supra* note 83, at art. 7.

104. *Id.* at art. 10.

105. "Contracts subject to approval by the state as stipulated by the law or administrative regulations of the People's Republic of China shall be established only when approval is granted." *Id.* at art. 7; see also Yuejiao, *supra* note 89, at 13.

106. ZHENG, *supra* note 82, at 52; ECL, *supra* note 86, at art. 35.

107. In some instances, breaching a contract and paying pecuniary damages may be economically efficient.

breaching party to ask for remedial measures or damages,¹⁰⁸ though it does not seem to place the same emphasis on specific performance.¹⁰⁹ For example, under the FECL, parties may provide in the contract what damages will be recoverable.¹¹⁰ In this regard, the FECL is more akin to traditional Western contract law than the ECL.

3. Dispute Resolution

Chapter VI of the FECL recommends the resolution of contractual disputes through a hierarchy of dispute resolution mechanisms. First, the FECL recommends that contractual disputes be settled through consultation or mediation.¹¹¹ Mediation is the most popular form of dispute resolution in the PRC¹¹² due to its philosophical¹¹³ and political¹¹⁴ support and because of the lack of a well developed legal system.¹¹⁵

The party in breach may gain enough from the breach to have a net benefit, even though that party compensates the injured party for resulting loss, calculated according to the subjective preferences of the injured party. If this is so, nonperformance and the consequent reallocation of resources is socially desirable, and economic theory not only sanctions but encourages breach.

FARNSWORTH, *supra* note 39, at 847.

108. The non-breaching party "is entitled to ask the party in default to adopt reasonable remedial measures or claim for damages. If the losses suffered by the other party are not paid in full after the remedial measures are taken, that other party retains the right to claim for damages." FECL, *supra* note 83, at art. 18.

109. Dernelle, *supra* note 6, at 356.

110. "The parties may agree upon in a contract that a certain amount of liquidated damages shall be paid to the other party if one party violates the contractual obligations." FECL, *supra* note 83, at art. 20.

111. *Id.* at arts. 37, 38.

112. It has been estimated that 90 percent of all civil cases arising in 1981 were mediated. LAW IN THE PEOPLE'S REPUBLIC OF CHINA 85 (Ralph H. Folsom & John H. Minan eds., 1989). Of the 40 million disputes mediated since 1981, approximately 80 percent were settled. *Id.*

113. Under Confucian philosophy, social conflict is seen to interfere with the attainment of an individual's highest potential. Cheng & Rosett, *supra* note 49, at 157. "The transcendent harmony of the natural world has inner aspects, forming a moral law felt by every sensitive human. People fulfill their highest potential when they conform their lives to that moral order and live in harmony with it. When they do so, there is no need for coercion to right behavior." *Id.*

114. The Communist party supports mediation because "it exemplifies communal obligations and rejects formal judicial mechanisms which traditionally have been characterized as pre-revolutionary institutions for class manipulation." LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 86.

115. There are several practical considerations that explain why mediation is the dispute resolution method of choice in the PRC: 1) the shortage of attorneys, 2) the limited availability of discovery, 3) the court's lack of injunctive

Mediation can be either formal or informal and is not necessarily compulsory, and requires the consent of both parties.¹¹⁶ However, formally mediated agreements are judicially enforceable.¹¹⁷

Should the parties to a contractual dispute choose to forego consultation and mediation, or if consultation and mediation fail to bring about a resolution to the dispute, the FECL allows parties to take their grievances to arbitration.¹¹⁸ Arbitration is a popular form of dispute resolution for foreign enterprises doing business in China.¹¹⁹ The FECL makes arbitration attractive to foreign enterprises because it provides for a "substantial measure of party autonomy."¹²⁰ First, arbitration can be held in either the PRC¹²¹ or abroad.¹²² The ability of the parties to determine where arbitration will occur has a substantial impact on individual autonomy.¹²³ Second, parties need not attempt to have their dispute mediated before proceeding to arbitration.¹²⁴ Third, the parties can choose which forum's law is to govern the arbitration.¹²⁵ Even if the law of the PRC is chosen, international custom may still apply.¹²⁶

or contempt powers, 4) the lack of personal liability insurance, and 5) the prevalence of under-trained, mediation-oriented judges. *Id.*

116. *Id.* at 86-87.

117. *Id.* at 87.

118. FECL, *supra* note 83, at art. 37.

119. Discussing foreign enterprises doing business in the PRC, attorney John T. Kuzmik with the U.S. law firm of Denton Hall stated, "We almost always suggest that you put in the contract an arbitration clause." *Solving Disputes in China Starts with the Contract*, ASIAN WALL ST. J., Feb. 2, 1995, available in 1995 WL-WSJA 2133591.

120. James A. R. Nafziger & Ruan Jiafang, *Chinese Methods of Resolving International Trade, Investment, and Maritime Disputes*, in LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 148, 162.

121. The major arbitration commissions in the PRC, the Foreign and Economic Trade Commission and the Maritime Arbitration Commission, are the two primary means for resolving Sino-foreign trade disputes. LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 124.

122. If arbitration is held in the PRC, the rules of the Chinese arbitral institution must apply. Tang Houzhi, *Arbitration - A Method Used by China to Settle Foreign Trade and Economic Disputes*, in LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 146. However, if arbitration is held abroad, the rules of another permanent arbitral body (such as the U.N. Commission on International Trade Law) may be used. *Id.*

123. Nafziger & Jiafang, *supra* note 120, at 148, 162.

124. FECL, *supra* note 83, at art. 37.

125. *Id.* at art. 5.

126. *Id.*

As a last resort, parties may take their case to court.¹²⁷ The judiciary of the PRC is divided into three categories: the local courts, the special courts, and the Supreme People's Court.¹²⁸ The local courts and the Supreme People's Court form a hierarchy of judicial review.¹²⁹ The local courts include the basic-level people's courts, the intermediate people's courts, and the higher people's courts.¹³⁰ The basic-level courts function on the city, county, and district level and act only as courts of original jurisdiction.¹³¹ The basic-level courts have economic divisions to hear commercial disputes.¹³² The intermediate people's courts function on the prefecture, autonomous region, and city level, directly under the control of the central government.¹³³ The intermediate court has original jurisdiction over disputes involving foreign persons.¹³⁴ The higher people's court functions at the provincial level and acts as both a trial court and a court of appeals.¹³⁵ The Supreme People's Court has administrative jurisdiction over the other courts, original jurisdiction in designated cases, and appellate jurisdiction over the higher and specialty courts.¹³⁶

The PRC also has specialty courts which exclusively handle certain kinds of cases.¹³⁷ Included within the specialty courts are the economic courts.¹³⁸ The economic courts have jurisdiction over disputes involving foreign enterprises and strictly domestic disputes.¹³⁹ The economic courts also hear domestic criminal cases.¹⁴⁰ The economic courts were created for the same reasons that general legal reform was undertaken in the PRC: to provide a forum that would produce "socialist modernization" and to encourage foreign investment.¹⁴¹

127. "In cases where an arbitration clause has not been stipulated in a contract or an arbitration agreement has not been made afterwards, the parties may take their case to the people's court." *Id.* at art. 38.

128. LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 174.

129. THOMAS CHIU ET AL., LEGAL SYSTEMS OF THE PRC 71 (1991).

130. LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 178-79.

131. *Id.* at 169-70.

132. *Id.* at 169.

133. *Id.* at 170.

134. *Id.*

135. *Id.*

136. *Id.*

137. For example, there are traffic police courts that handle only civil auto accident cases. *Id.* at 169.

138. Paul A. Allen & Marc S. Palay, *Economic Courts*, in LAW IN THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 112, at 183.

139. *Id.*

140. *Id.*

141. *Id.* at 184; see discussion *supra* Part III.A.3.

The FECL disfavors judicial proceedings. Parties only have access to the people's court if the contract did not provide for arbitration and the parties could not agree on arbitration after the dispute arose.¹⁴² It is not clear whether the people's court is the only judicial remedy under the FECL.¹⁴³ The FECL provides that parties "*may* take their case to the people's court."¹⁴⁴ The current practice supports the interpretation that parties may choose to settle their disputes in other judicial forums.¹⁴⁵

IV. RECENT SINO-FOREIGN DISPUTES

Despite the FECL's pro-Western slant, a series of highly publicized contractual disputes involving Chinese and foreign enterprises during the early 1990s caused concern that the instrumentalist view of law still governs Sino-foreign economic transactions in the PRC. The two disputes symbolizing the international business community's concern over contractual enforcement in the PRC involved McDonald's Corporation and Lehman Brothers Commercial Corporation.¹⁴⁶ Despite the tremendous amount of international publicity generated by these disputes and their impact on the business community, their resolution did little to resolve the debate as to the role of law in the PRC.

A. *McDonald's*

McDonald's had good reason to be optimistic when it opened its first restaurant in Beijing in April of 1992.¹⁴⁷ The corporation thought it had a twenty-year lease in arguably the best location in China.¹⁴⁸ The largest McDonald's restaurant in existence,¹⁴⁹ on

142. FECL, *supra* note 83, at art. 38.

143. ZHENG, *supra* note 82, at 67.

144. FECL, *supra* note 83, at art. 38 (emphasis added).

145. Henry Zheng based this assertion on reports that the jurisdiction of New York, Japan, and Hong Kong courts had been accepted in Sino-foreign contracts. ZHENG, *supra* note 82, at 67.

146. Jeffrey Hoffman, *U.S. Firms Pursue Market in China Despite News of Problems* FORT WORTH STAR-TELEGRAM, Feb. 9, 1995, at 1, available in 1995 WL 5621387.

147. The Beijing restaurant was the third opened in the PRC. Janet Snyder, *McDonald's Draws the Crowds in Beijing Debut*, Reuters, April 23, 1992, available in LEXIS, World Library, Arcnws File.

148. The restaurant was located near Tiananmen Square on Wangfujing street, the busiest shopping street in China. *Id.* "Every day more than 400,000 people—roughly the population of Luxembourg—stream past the corner where McDonald's Beijing is nestled." *Id.*

149. The restaurant had 29 cash registers and a 700-seat capacity. *Id.*

opening day it set a chain record by serving approximately 40,000 customers.¹⁵⁰ Despite this auspicious start, McDonald's optimism was belied when two-and-a-half years later, it was evicted to make way for a massive shopping complex.¹⁵¹ The eviction captured significant attention in the international business community. McDonald's complained that it was a party to a binding contract.¹⁵² As a result, reporters described the eviction as an example of the PRC's unwillingness to enforce contractual obligations.¹⁵³

However, in retrospect, the McDonald's dispute added little to the role of law debate in the PRC. First, there were questions as to the validity of McDonald's lease. McDonald's began negotiating with the Beijing authorities for the Beijing site in 1989.¹⁵⁴ However, the PRC did not formally recognize the right of foreign entities to lease state-owned property until 1990.¹⁵⁵ Consequently, it has been asserted that McDonald's only had an arbitrary arrangement with the Beijing authorities, which

150. Nicholas D. Kristof, "Billions Served" (and That Was Without China), N.Y. TIMES, April 24, 1992, at A4.

151. Oriental Plaza was designed as a residential, commercial, and office complex, which would cover 108,000 square meters in downtown Beijing at a cost of about \$1.2 billion. Ted Plafker, *Is This the End of a Beautiful Friendship?*, S. CHINA MORNING POST, Nov. 27, 1994, at 6, available in LEXIS, World Library, Schina File.

152. The Wangfujing McDonald's restaurant issued a statement saying, "We believe we have a legal right to be at this location." *Id.*

153. "[S]erious investors likewise view this apparent breach of contract as a frightening indication that China's business climate is inhospitable to the concept of the rule-of-law." *Id.* "When the Chinese government recently ordered McDonald's, barely into a 20-year lease, to relocate its profitable restaurant near the center of Beijing, the eviction notice was heard around the business world. . . . [T]he McDonald's incident has fueled skepticism about the wisdom of doing business and investing in China." Stanley B. Lubman, *Doing Business with China: A Big Mac Attack?*, TULSA WORLD, Jan. 11, 1995, at N13, available in LEXIS, World Library, Busdfl File.

154. Plafker, *supra* note 151.

155. "Chinese law did not provide for a land-use lease, so McDonald's 'couldn't lose its lease.'" Toh Han Shih, *Know the Rules in China, Otherwise Fill the Gap*, BUS. TIMES, Nov. 25, 1995, at 4, available in 1995 WL 8502830. The PRC amended its Constitution to permit the transfer of the use of land in 1988. However, it was not until 1990 that the Interim Regulations Concerning the Assignment and Transfer of the Right to the Use of the State-Owned Land in the Urban Areas, and the Interim Measures for the Administration of the Foreign-Invested Development and Management of Tracts of Land were promulgated. It was these laws that formally gave foreign investors the right to acquire the right to use property by entering into a lease with a lessor. See Provisional Regulations of the People's Republic of China Concerning the Grant and Assignment of the Right to Use State Land in Urban Areas, Act of May 24, 1990, art. 28, 2 China L. for Foreign Bus. Reg. (CCH) P 14-716, at 18,665.

therefore could be arbitrarily breached.¹⁵⁶ In contrast, foreign enterprises which entered into similar agreements based on recent laws regarding land use in Beijing were able to reach relatively quick out-of-court settlements with the Beijing authorities in the dispute over the shopping center development.¹⁵⁷

Second, the merits of McDonald's complaint were never formally heard.¹⁵⁸ McDonald's chose not to pursue legal action inside or outside of the PRC.¹⁵⁹ Consequently, because of questions about the validity of McDonald's lease and the lack of public resolution, the McDonald's dispute failed to be a definitive example of the operation of law from an instrumentalist perspective.

B. *Lehman Brothers*

Similarly, the resolution of the Lehman Brothers dispute provided little insight into the question of whether the PRC resolves Sino-foreign contract disputes according to the rule of law. In December of 1994, the investment bank Lehman Brothers filed suit in New York against China National Metals & Minerals Import & Export Corporation (Minmetals) and its Hong Kong subsidiary, Minmetals International Non-Ferrous Metals

156. Michael Michalak, Deputy Director of the Economic Affairs Unit of the Office of Chinese and Mongolian Affairs in the U.S. Department of State, Remarks to the Southeast Michigan-China Network (1995) in *China in Transition - The Impact at Home and Abroad*, 4 D.C.L. J. INT'L L. & PRAC. 241, 286 (1995).

157. Michael Michalak cited Shakeys as one of the firms that was able to obtain a quick settlement. *Id.*

158. *See id.*

159. Donald Whaley, the president of McDonald's China Development Company, issued the following press release regarding the dispute with the PRC:

In response to your Dec. 2 page-one article that mentioned McDonald's operations in China and the current situation surrounding our Wangfujing restaurant in Beijing.

As it relates to McDonald's, I would like to say we absolutely are committed to a long-term strategy of growth in China. In fact, we will open our second restaurant in Shanghai and our seventh restaurant in Beijing this month, bringing the total in China to 27.

We are not considering legal action regarding our Wangfujing restaurant. We have an excellent relationship with the Beijing government and look forward to that relationship continuing for many years. Also we expect an amicable resolution will be found regarding our Wangfujing restaurant.

Letter to the Editor, *McDonald's Intends to Stay in China*, WALL ST. J., Jan. 3, 1995, at 9.

Trading (Non-Ferrous),¹⁶⁰ Lehman Brothers was attempting to recover more than \$44 million lost in foreign-exchange transactions allegedly entered into between Lehman Brothers and Non-Ferrous and guaranteed by Minmetals.¹⁶¹

At the time, observers saw the case as a referendum on the PRC's creditworthiness.¹⁶² The international business community's concern was that state-owned companies like Minmetals would not stand behind the obligations of their offshore units.¹⁶³ However, the New York court dismissed the case against Minmetals, holding that a guarantee Lehman Brothers had received had not been signed by anyone with the authority to bind Minmetals and that the letters of undertaking which Lehman received from Minmetals did not constitute guarantees that it would back Non-Ferrous' trades.¹⁶⁴ Instead of implicating the legal system of the PRC, the Lehman Brothers dispute implicated Lehman Brothers' ability to document its transactions.¹⁶⁵

Consequently, neither of the two Sino-foreign disputes that symbolized the international business community's concern over the PRC's enforcement of contractual obligations provided any significant insight into the role of law in the PRC. Despite their widespread publicity, neither dispute helped to resolve the question of whether Sino-foreign contractual disputes in the PRC can be resolved according to the rule of law.

160. *Lehman Bros. Commercial Corp. v. Minmetals, Int'l.* [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,841, 1995 WL 380119 (S.D.N.Y. June 26, 1995).

161. *Id.*

162. For example, Standard and Poor's intimated that it might lower the PRC's credit rating over the Lehman Brothers dispute and other incidents.

Analysts said the [Standard and Poor's] lawyer's language was unusually strong given that Standard & Poor's tends to issue low-key statements. "It's definitely a shot in front of the bow," said Michael Baer, senior vice president at the London branch of Bank Julius Baer & Co. Mr. Baer said that if Standard & Poor's were to lower its rating for China sovereign debt "that would be quite a big blow for China" in its effort to raise capital internationally to fund infrastructure projects.

Guyot, *supra* note 2.

163. As a result of the dispute, "Western financial houses reassessed their China risks while some even cut credit available to Chinese state-owned companies." Craig S. Smith, *Lehman Bros. Legal Setback May Hurt Firm's Remaining Business in China*, WALL ST. J., June 30, 1995, at B5.

164. *Lehman Bros. v. Minmetals*, [1995] Fed. Sec. L. Rep. (CCH) at 93,064.

165. The former head of credit at a competing U.S. investment bank stated, "It has already been discounted in the market. What it shows is that Lehman had a documentation problem." Henry Sender, *Beijing: Sloppy Joes*, FAR E. ECON. REV., July 13, 1995, at 82, available in 1995 WL-FEER 9081058.

V. DEFINING THE RULE OF LAW

To assess the PRC's ability to implement the rule of law in the governance of Sino-foreign economic transactions, it is necessary to define the institutional characteristics that are essential components of the rule of law.¹⁶⁶ These institutional characteristics can then be compared to the current principles of legal organization in the PRC, thus exposing obstacles to and potential strategies for achieving the rule of law.

A. *The Institutional Versus the Values Approach*

Professor Geoffrey Walker¹⁶⁷ has identified two possible approaches for defining the rule of law: an institutional approach and a values approach.¹⁶⁸ Professor Walker's institutional approach defines the rule of law by examining the institutions¹⁶⁹ designed to safeguard it in countries¹⁷⁰ where the rule of law is commonly thought to prevail.¹⁷¹ By focusing on the immediate purpose the institution was created to serve, common principles of legal organization begin to surface.¹⁷² Countries that adhere to these principles are said to observe the rule of law.¹⁷³

In contrast, the values approach defines the rule of law according to the broad objective that it is thought to serve in modern Western society.¹⁷⁴ For example,

The function of the legislative in a free society under the rule of law is to create and maintain the conditions which will uphold the

166. Defining the rule of law according to institutional characteristics found in countries where the rule of law is commonly recognized to prevail focuses on the principles of legal organization of society. GEOFFREY DE Q. WALKER, *THE RULE OF LAW: FOUNDATION OF CONSTITUTIONAL DEMOCRACY* 9-11 (1988). Using common institutional characteristics to define the rule of law is preferable to using common values because it avoids clouding the definition with cultural bias or ethnocentricity. *Id.* at 12.

167. Professor Walker is Professor of Law at the University of Queensland, Australia.

168. WALKER, *supra* note 166, at 9.

169. Professor Walker's analysis includes examining the principles which dictate how the rule of law is to be safeguarded, the institutions that actually safeguard the rule of law, and the procedures these institutions use for that purpose. *Id.*

170. As examples, Professor Walker uses the United States, the United Kingdom, Germany, France, and New Zealand. *Id.* at 10.

171. Professor Walker recognizes the circularity of this approach. *Id.* at 9. That is, by defining the rule of law in terms of the means by which it is safeguarded in a particular country, he assumes that the rule of law prevails in that country. *Id.*

172. *Id.* at 10.

173. *Id.* at 23.

174. *Id.* at 11.

dignity of man as an individual. This dignity requires not only the recognition of his civil and political rights but also the establishment of the social, economic, educational and cultural conditions which are essential to the full development of his personality.¹⁷⁵

The problem with this approach is that it inseparably links the rule of law with liberal democratic free-market societies.¹⁷⁶ "The rule of law becomes confused with social justice, democracy, human rights . . . and itself lacks the sharpness to serve any useful purpose."¹⁷⁷ Professor Walker suggests that it is wrong to presume that a recognizable form of the rule of law could not exist in a theocratic or secular-but-socialist society, where the legal system might not be structured around the development of the individual.¹⁷⁸ Consequently, Professor Walker chooses to define the rule of law according to the institutional approach.

B. Institutional Characteristics

Using the institutional approach, Professor Walker found a set of principles of legal organization common to many countries ascribing to the rule of law.¹⁷⁹ Using Professor Walker's principles to determine whether the rule of law is dominant in a society demonstrates that a country's organization as a liberal,

175. *Report of Committee I: The Legislative and the Rule of Law*, INT'L CONG. OF JURISTS, NEW DELHI, INDIA, Clause I, (1959) reprinted in INTERNATIONAL CONGRESS OF JURISTS, THE RULE OF LAW IN A FREE SOCIETY 4 (New Delhi 1959).

176. *Id.* at 12.

177. M. D. A. Freeman, *The Rule of Law - Conservative, Liberal, Marxist and Neo-Marxist: Wherein Lies the Attraction?*, in PERESTROIKA AND THE RULE OF LAW 37, 43 (W. E. Butler ed., 1991).

178. As an example, Professor Walker notes:

The purpose of Islamic legal thought is . . . to discover the precise terms of the divine will as expressed through the Qur'an and through the sayings and actions of the Prophet Mohammed [T]he full development of individual capacities is irrelevant.

. . . But it would be wrong to conclude that a recognizable form of the rule of law could not exist in a strictly Islamic society. The shariy'a (religious) criminal law, for example, imposes stringent requirements on the conduct of criminal trials, particularly in relation to evidence and the burden of proof It is certain that the values that gave rise to shariy'a criminal procedure had nothing to do with Western ideas of individual rights. . . . But if the result of these rules and of this juristic-theological thinking is that persons accused of a crime do in practice have an opportunity to defend themselves and that the innocent have a reasonable prospect of going free, what right have we to deny that the rule of law is, to that extent, a going concern in that country?

WALKER, *supra* note 166, at 12-13.

179. *Id.* at 10-11.

free-market democracy is not a prerequisite to the rule of law.¹⁸⁰ As long as a society observes these principles in "letter and spirit," it is a society under the rule of law regardless of the reason for observing such principles.¹⁸¹

1. Laws Against Private and Public Coercion

One necessary characteristic of a society governed by the rule of law is that laws must exist that protect individuals from private coercion.¹⁸² The state must ensure that individuals will not "break the rules that all should see are in their interest as long as all obey."¹⁸³ Thus the government protects the individual's interest in autonomous choices. According to capitalist theory, this leads to wealth-maximizing behavior for the individual and for society.¹⁸⁴ However, the mere existence of laws designed to protect the individual from private coercion is insufficient. To escape Hobbes' state of nature, the government must be capable of enforcing its laws against private coercion.¹⁸⁵ The rule of law depends on "the existence of effective government capable of maintaining law and order."¹⁸⁶

Similarly, the rule of law provides a check on the government by preventing it from exercising arbitrary power.¹⁸⁷ Hence the rule of law advances the goal of individual freedom in two ways: by restraining private coercive action and by restraining the government.¹⁸⁸ Like the prohibition on coercive private action, the "government under the law" principle must be enforced.¹⁸⁹ There must be effective procedures and institutions to prevent the arbitrary exercise of governmental power.¹⁹⁰ The principle of

180. *Id.* at 23.

181. *Id.*

182. "Rule of law must mean freedom from private lawlessness and anarchy." *Id.* at 24.

183. Segall, *supra* note 28, at 996.

184. See discussion *supra* Part II. However, in order to implicate the rule of law, the purpose behind the existence of laws to protect individuals from private coercion need not be to support a capitalist economy. See WALKER, *supra* note 166, at 23.

185. WALKER, *supra* note 166, at 28.

186. *Report of Committee II: The Executive and the Rule of Law*, INT'L CONG. OF JURISTS, NEW DELHI, INDIA (1959), reprinted in INTERNATIONAL CONGRESS OF JURISTS, THE RULE OF LAW IN A FREE SOCIETY 6 (New Delhi 1959).

187. "[T]he rule of law is contrasted with every system of government based on the exercise by person in authority of wide, arbitrary, or discretionary powers of constraint." A.V. DICEY, INTRODUCTION TO THE LAW OF THE CONSTITUTION 188 (9th ed. 1939).

188. Segall, *supra* note 28, at 996.

189. WALKER, *supra* note 166, at 29.

190. An example of such procedures and institutions is judicial review of executive action. *Id.*

government under law cannot be effective unless the individual has legal recourse and the possibility of enforcement against the sovereign.¹⁹¹

2. Normativism

One of the main principles underlying the rule of law is that the law must be normative—that is, “the law should be such that people will be able to be guided by it.”¹⁹² There are three components to the requirement of normativism: certainty, generality, and equality.¹⁹³ Certain laws provide guidance to society by being prospective, open, clear, and relatively stable.¹⁹⁴ Furthermore, the certainty principle curtails the arbitrary power of the courts and the police by ensuring that laws are not excessively vague.¹⁹⁵ The generality principle ensures that laws are not particularized to individuals.¹⁹⁶ Unless laws are generalized, they do not provide norms for behavior,¹⁹⁷ but instead represent “a series of patternless exercises of state power.”¹⁹⁸ Finally, the corollary of normativism is equality.¹⁹⁹ The idea of equality means that the law is applied to everyone equally.²⁰⁰ When the law is not applied to everyone equally, its

191. Professor Walker cites the failure of the pre-constitutional codifications of eighteenth-century Prussia and Austria to establish the rule of law. *Id.* Though the codes were “prospective, clear, general and predictable,” because no independent courts existed, there was no check on the sovereign’s arbitrary exercise of power. *Id.*

192. Segall, *supra* note 28, at 995 (quoting Joseph Raz, *The Rule of Law and the Virtue*, in *THE AUTHORITY OF LAW* 213 (1979)).

193. It is the existence of certainty, generality, and equality that enable the law to guide its subjects. WALKER, *supra* note 166, at 51.

194. *Id.* at 25.

195. As an example of an excessively vague law, Professor Walker cites Article 16 of the Soviet Criminal Code which prohibited all “socially dangerous acts.” *Id.* The power to determine what acts were “socially dangerous” was left to those who enforced it, inviting arbitrary and discriminatory enforcement. As the U.S. Supreme Court noted with regard to vague laws, “It would certainly be dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large.” *United States v. Reese*, 92 U.S. 214, 221 (1876).

196. WALKER, *supra* note 166, at 25.

197. *Id.*

198. *Id.* In a free market economy, generality renders the outcome of economic transactions predictable, encouraging mutually beneficial exchanges. See FRANZ NEUMANN, *THE RULE OF LAW* 213 (1986); see also discussion *supra* Part II.

199. WALKER, *supra* note 166, at 51.

200. Professor Dicey defined equality as follows:

In England the idea of legal equality, or the universal subjection of all classes to one law administered by ordinary courts, has been pushed to its

value as a guide to behavior is diminished, as is society's respect for the law.²⁰¹

3. Independent Judiciary and Legal Profession

An independent judiciary has long been recognized as a requisite institutional characteristic of a society governed by the rule of law.²⁰² In the context of the rule of law, one of the traditional functions of the judiciary is to review legislative and executive acts.²⁰³ Hence, the judiciary serves as the institution which ensures that the principle of government under the law is enforced.²⁰⁴ However, if the judiciary is not independent, it cannot adequately perform this role.²⁰⁵ Two common structural safeguards of judicial independence are security of tenure²⁰⁶ and protection from reduction in remuneration during that tenure.²⁰⁷

According to Professor Walker, an independent judiciary must also be accompanied by an independent legal profession.²⁰⁸

utmost limit. With us every official, from the Prime Minister down to a constable or a collector of taxes, is under the same responsibility for every act done without legal justification as any other citizen.

DICEY, *supra* note 187, at 193.

201. See WALKER, *supra* note 166, at 26 (discussing the increased likelihood of compliance with laws known to be equally applicable to everyone).

202. "[T]here is no liberty, if the power of judging be not separated from the legislative and executive powers." THE FEDERALIST NO. 78, at 466 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (quoting Montesquieu's SPIRIT OF LAWS); see Charles de Secondat, baron de Montesquieu, THE SPIRIT OF LAWS 163 (J.V. Prichard ed. Rev. vol. & Thomas Nugent trans., 1991) (1748).

203. KEITH, *supra* note 24, at 182.

204. See discussion *supra* Part V.B.1.

205. It has been noted that:

[T]he power of the law, and of the judiciary, is in its independence. . . . The power of the law and of those who administer it is in the very fact that they are not competing with the more partisan powers of the executive and even the legislature. Such independence of the 'judicial department' may indeed be regarded as the very definition of the 'rule of law': it is certainly an important part of it. If the law and the judiciary come under government control, they cease to be necessary as such; if courts become a part of political struggles, they merely simulate parliament and parties and lose their function. Either way, the partisan administration of law is in fact the perversion of law, and the denial of the rule of law.

WALKER, *supra* note 166, at 30 (quoting R. Dahrendorf, *A Confusion of Powers: Politics and the Rule of Law*, 40 MOD. L. REV. 1, 9 (1977)).

206. "[N]othing can contribute so much to [the judiciary's] firmness and independence as permanency in office[;] this quality may therefore be justly regarded as an indispensable ingredient in [the] constitution." THE FEDERALIST, *supra* note 202, at 466.

207. WALKER, *supra* note 166, at 31.

208. *Id.* at 36.

An independent legal profession is necessary to provide adequate defense to the accused in a criminal trial.²⁰⁹ Furthermore, should the judiciary become tainted by the influence of either the legislature or the executive, an independent bar can remind the judiciary of its role in enforcing the government under law principle and "generally keep the rule of law alive."²¹⁰

4. Natural Justice

Courts in societies governed by the rule of law share two common characteristics. First, they observe the principle of natural justice.²¹¹ Procedurally, natural justice requires that the tribunal be unbiased, that both sides of the case be heard, and that the court be open to the public.²¹² The function of natural justice is "to legitimate, to ensure the acceptability, of the court as a dispute-settling mechanism by requiring rational and even-handed procedures that demonstrate a concern for individuals and for the individual's problems."²¹³ In that sense, the principle of natural justice is closely tied to the principle of judicial independence in that both increase societal respect for and belief in the law. Second, courts in nations governed by the rule of law are accessible.²¹⁴ If courts are inaccessible, natural justice can never be administered. An individual's ability to vindicate one's legal rights is illusory if hampered by long delays or excessive costs.²¹⁵

Like the courts, the enforcement of laws must be impartial in a nation governed by the rule of law.²¹⁶ The courts, while exercising a great deal of discretion, must be unbiased to further the goals of predictability and of instilling a respect for and belief in the law. However, the courts are not the only body with wide discretion. Even in a society with clear and precise laws, some discretion will exist on the part of those who enforce the law.²¹⁷

209. *Id.*

210. Professor Walker cites the legal profession's role in India during the "Gandhi emergency." *Id.* at 37. There, attorneys "continued to press for habeas corpus on behalf of thousands of detainees, despite increasingly obvious risks to the lawyers themselves." *Id.*

211. Professor Walker notes that the principle of natural justice dates back to ancient times. *Id.* at 37. "Does our law judge a man without first giving him a hearing . . . ?" *Id.* at 412 n.151 (quoting *John* 7:51).

212. *Id.* at 37.

213. *Id.* at 38.

214. *Id.* at 40.

215. *Id.*

216. *Id.* at 40-41.

217. "The police decide which laws to enforce and whom to arrest. Prosecutors decide whether to bring charges and for which offenses. Prosecutors also may elect to accept or reject offers of guilty pleas and to make or withhold

That discretion "should not be allowed to pervert the law" in a society governed by the rule of law.²¹⁸

5. Social Values and an Attitude of Legality

There must be an attitude of legality for the rule of law to prosper.²¹⁹ The source of the values that the rule of law protects is to be "found in the patterns of behavior and belief of the people, and their crystallization through the institutions of the legal system is a continuous process."²²⁰ Without an attitude of legality, the institutions that safeguard the rule of law can break down or be subverted.

Supporting the attitude of legality is the principle that society's values must remain reasonably in accord with the law. In a society governed by the rule of law, the law must reflect society's values.²²¹ Otherwise, respect for and belief in the law will be diminished.²²² The mechanism for ensuring this alignment in Western nations is ordinarily two-party or multi-party democracy.²²³ However, any system will work as long as it allows individuals to be heard without fear of reprisal.²²⁴

VI. ASSESSING THE RULE OF LAW IN THE PRC

The application of Professor Walker's principles to the current legal organization of the PRC indicates that both structural and sociopolitical obstacles block the operation of the FECL according to the rule of law. Given time and the proper motivation, the structural deficiencies can be remedied. Further, although the sociopolitical obstacles are of greater concern, at least theoretically, these too can be overcome through the influence of economic development and the power of market forces.

recommendations of sentence. In all of these respects, the exercise of discretion is virtually uncontrolled." PETER W. LOW ET AL., *CRIMINAL LAW* 65 (2d ed. 1986).

218. WALKER, *supra* note 166, at 41.

219. *Id.*

220. *Id.*

221. *Id.* at 27.

222. The societal frustration with the law which results when the law is not in accord with society's values can find expression in "arbitrary and lawless actions." *Id.*

223. *Id.*

224. As an alternate system, Professor Walker cites the Saudi Arabian procedure whereby any subject of the kingdom can obtain an audience with the king to air legal grievances or debate the interpretation of a particular applicable law. *Id.* at 28.

A. Analysis of the Structural Obstacles

Like other Communist countries that have attempted to implement the rule of law, the PRC is plagued by several structural deficiencies, most notably a shortage of trained legal personnel and the absence of precedential judicial decisions. However, because of the limited scope of the FECL, these deficiencies could be remedied without dramatically altering the legal system of the PRC.

1. The Shortage of Trained Legal Personnel

The shortage of trained legal personnel in the PRC implicates several of Professor Walker's principles of legal organization essential to the rule of law. Despite having a population of over one billion, the PRC has only about 380,000 legal personnel, leading to long delays in bringing a legal action.²²⁵ The shortage of legal personnel implicates the principles of natural justice, and of an independent judiciary and legal profession. The principle of natural justice requires that individuals have the right to have their disputes adjudicated in an even-handed way before an unbiased tribunal.²²⁶ The existence of long delays such as those necessarily created by the shortage of legal personnel in the PRC makes that right illusory.²²⁷ The lack of legal personnel in the PRC also implicates the principle of an independent judiciary and legal profession. The judiciary and legal profession ensure that the principle of government under the law is enforced by reviewing legislative and executive acts.²²⁸ A shortage in judges and attorneys results in a shortage in oversight.

Aside from being relatively few in number, judges in China often have relatively little legal education.²²⁹ This deficiency implicates Professor Walker's certainty principle in that an under-trained judiciary will be less likely to apply laws uniformly such that individuals may be guided by them.²³⁰ Further, an under-trained judiciary will be less capable of reviewing the acts of other governmental bodies, implicating the independence principle.²³¹

225. Leng, *supra* note 74, at 90. One reason mediation is the most popular form of dispute resolution in China is because the shortage of legal personnel makes the courts inaccessible. See discussion *supra* Part III.B.3.

226. See discussion *supra* Part V.B.4.

227. See discussion *supra* Part V.B.4.

228. See discussion *supra* Part V.B.3.

229. MACKERRAS, *supra* note 45, at 146.

230. See discussion *supra* Part V.B.2.

231. It has been said that "[j]udicial independence is inseparable from judicial competence." William W. Schwarzer, *Democracy's Dawn: American Judges and the Rule of Law Abroad*, 31 No. 4 JUDGES' J., 34, 36 (1992).

Nevertheless, the shortage of legal personnel is not a fatal flaw in the context of governing Sino-foreign disputes. First, the number of attorneys in the PRC is growing.²³² Second, the FECL does not seem to bind parties to domestic courts.²³³ Consequently, parties can choose to go outside the legal system of the PRC to take advantage of certain, accessible, and independent foreign judiciaries.

However, even if parties choose to adjudicate their dispute outside of the PRC's legal system, the victorious party still has to enforce its award in a Chinese court.²³⁴ To improve the responsiveness of the PRC's legal system to foreign enterprises and thus attract more foreign investment, the PRC should consider splitting the special economic courts into those with jurisdiction over domestic matters only and those with jurisdiction over Sino-foreign disputes.

The concept of adopting specialized courts to handle business litigation in order to attract new investment is not new. In the United States, four states have created specialized business courts while ten others are considering the concept.²³⁵ Furthermore, this was the original goal behind the creation of the economic courts in the PRC.²³⁶

However, the existing economic courts in the PRC have jurisdiction over both domestic and foreign disputes.²³⁷ Consequently, these courts hear disputes adjudicated according to both the ECL and the FECL. Because the philosophical

232. The number of attorneys in the PRC grew from about 3,000 in 1980 to almost 44,000 in 1989. MACKERRAS, *supra* note 45, at 146. "Although at present there are still fewer than 100,000 lawyers in China (a ratio of 12,000:1, against 8,000:1 in Japan and 360:1 in the [United States]), Beijing has set the goal of 150,000 by the turn of the century, and twice that number by 2010." Gerald Chen, *The "Civil Society" is Expanding by the Day: Civil Rights on the Mainland*, WINDOW (HONG KONG), Nov. 8, 1996, available in 1996 WL 12924330.

233. See discussion *supra* Part III.B.3.

234. "Chinese arbitration isn't the worst thing in the world. . . . But if you get an award, you're stuck enforcing the awards in Chinese courts. Sometimes local pressures will lead a court to avoid or delay the execution of an arbitration award." *Solving Disputes in China Starts with the Contract*, *supra* note 119, at 8.

235. New York, Delaware, Illinois, and North Carolina each have created specialized business courts. ACCA *Endorses Specialized Business Courts*, METRO. CORP. COUN., Aug. 1996, at 32, available in LEXIS, Legnew Library, Mcc File. California, Connecticut, Florida, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, Texas, and Wisconsin have considered or are considering creating such courts. *Id.*; see also Susan D. Etkind, *A Connecticut Commercial Court?*, CONN. L. TRIB., Jan. 13, 1997, at 3, available in LEXIS, Legnew Library, Clt File.

236. Gregory S. Kolton, *Copyright Law and the People's Courts in the People's Republic of China: A Review and Critique of China's Intellectual Property Courts*, 17 U. PA. J. INT'L ECON. L. 415, 428 (1996).

237. See discussion *supra* Part III.B.3.

foundations for these two bodies of law are so different,²³⁸ some advantages of specialization are lost. For example, judges in the economic courts are more likely to resolve contractual disputes using traditional Chinese conceptions of the role of law rather than according to the rule of law.²³⁹ As a result, the economic courts have not been particularly popular with foreign enterprises.²⁴⁰ By dividing the economic courts into foreign and domestic courts, the PRC would reduce the number of judges eligible to adjudicate Sino-foreign disputes. Having a smaller pool of judges to educate makes it easier to overcome traditional Chinese conceptions of the role of law and to implement the rule of law. Further, such a division would be consistent with the division of contract law in the PRC between the ECL and FECL.

Another drawback to the economic courts is that the judges may not be adequately trained.²⁴¹ The foreign economic courts could be staffed and trained on an accelerated schedule concerning the details of the FECL and the precepts of the rule of law. This process would then establish a relatively more familiar forum for foreign enterprises without altering the rest of the PRC's legal system. Creating foreign economic courts to adjudicate Sino-foreign disputes would make the dispensation of justice in the PRC "faster, more consistent, more efficient, more predictable and of a higher quality, resulting in a greater confidence in [the PRC's] judicial system."²⁴²

238. See discussion *supra* Part III.B.

239. According to Confucian philosophy, strict adherence to the letter of the law is eschewed in favor of deference to the parties' relationship and maintaining the moral order. See discussion *infra* Part VI.B.1. Judges in the PRC's economic courts seem to adhere to this philosophy when adjudicating cases rather than to the rule of law. "From the perspective of most of the economic court judges we interviewed, contract enforcement is not best accomplished by too rigid an insistence on the letter of the law and the precise terms of the contract. The letter must be softened by deference to the relationship of the party and the moral demands of accommodation." Cheng & Rosette, *supra* note 49, at 225.

240. For example, over 1,000 economic courts were created from the mid-1980s through 1989. Allen & Palay, *supra* note 138, at 183. However, by 1989, not one foreign company had appeared in an economic court. *Id.* at 188.

241. *Id.* at 184.

242. John L.W. Garrou, *These Courts Aren't Business as Usual; Special Courts Could Ease Burden on Judicial System Due to Complex Litigation*, FULTON COUNTY DAILY REP., May 3, 1996, available in LEXIS, Legnew Library, Fulton File (quoting the North Carolina Commission on Business Laws and the Economy's report discussing the adoption of a specialized business court in North Carolina).

2. Lack of Published Decisions

A second example of an institutional deficiency in the legal system of the PRC is the shortage of published decisions.²⁴³ Currently, only the Supreme People's Court publishes cases.²⁴⁴ There is debate about whether these cases carry the legal force of precedent, though a strong argument can be made that they do.²⁴⁵ A lack of published decisions violates the principle of normativism required in a legal system operated according to the rule of law.²⁴⁶ Published decisions with precedential value provide guidance to individuals about the nature of the law and how to modify their behavior accordingly, thus improving the ability of individuals to order their economic affairs efficiently.

To provide guidance and comfort to foreign enterprises in the PRC, in conjunction with establishing foreign economic courts, a procedure should be established whereby those courts publish their decisions that will be accorded precedential value.²⁴⁷ Creating a separate court that publishes decisions of precedential value would dramatically increase the comfort level of foreign enterprises operating in the PRC. Furthermore, this would be consistent with the FECL's underlying policy of adopting a

243. The power to both enact and interpret statutes is reserved to the Standing Committee of the National People's Congress under Article 67 of the Constitution of the PRC. 1 STATUTES AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA § 821204 (Univ. of East Asia Press & Inst. of Chinese Law (Publishers) Ltd. 1987) [hereinafter PRC CONSTITUTION].

244. The Standing Committee delegated some of its interpretive powers to the Supreme People's Court. Nanping Liu, "Legal Precedents" with Chinese Characteristics: Published Cases in the Gazette of the Supreme People's Court, 5 J. CHINESE L. 107, 120 (1991). In 1985, the PRC first began reporting cases in the Gazette of the Supreme People's Court. The Constitution grants the Supreme People's Court the authority to "supervise the administration of justice by the local people's courts at different levels and by the special people's courts." PRC CONSTITUTION, *supra* note 243.

245. Scholars who contend that the published cases do not carry the force of precedent point out that the cases are never cited in lower courts as the authority for a particular holding. Liu, *supra* note 224, at 117. However, Nanping Liu makes a powerful argument that the Supreme People's Court intends cases published in the Gazette to be binding precedent. *Id.* at 118-22. "As a practical matter, the Supreme Court understands, as do the lower courts, that the Gazette constitutes a legal source with binding force within the judiciary, despite the fact that the Court specifically forbids the lower courts to cite the reported decisions in their judgments." *Id.* at 121.

246. See discussion *supra* Part V.B.2.

247. This same suggestion was made in the context of establishing business courts in the United States. Garrou, *supra* note 242.

contract law which mirrors traditional Western contract law for the purpose of attracting Western capital and technology.²⁴⁸

B. Analyzing the Sociopolitical Obstacles

Of greater concern to scholars than the institutional deficiencies in the PRC are the sociopolitical obstacles to the rule of law. More specifically, some scholars perceive that there is a lack of "an attitude of legality" among the populace and the government of the PRC.²⁴⁹ Despite the PRC's legal reforms, "corruption and disregard for the rule of law remain a primary concern."²⁵⁰ However, this obstacle may be overcome by the influence of economic development and the power of market forces.

1. The Lack of an Attitude of Legality

The populace's lack of "an attitude of legality" is rooted in the influence of Confucian philosophy and a general distrust and dislike of the law.²⁵¹ A traditional strand of Confucian thought holds that people fulfill their highest potential when they live in harmony with the moral order of the universe.²⁵² The law is more than a set of commands and prohibitions, it is a set of relationships and interactions that produce order and harmony.²⁵³ Resorting to the law to resolve a dispute when the law is only a set of commands and prohibitions "kills [the] spirit

248. A well developed body of case law can be a magnet for business. For example, the number of corporations that incorporate in Delaware far exceed the number incorporated in any other state.

The value of a Delaware domicile to firms is more than an up-to-date code; Delaware also offers a comprehensive body of case law, which is not easily replicated by another state, and a handful of experienced judges. These factors afford firms greater predictability of the legal outcomes of their decisions, facilitating planning and reducing the costs of doing business.

Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 280 (1985).

249. Feinerman, *supra* note 37, at 67.

250. *Id.*

251. In the Confucian conception, the law is not applied through the formal interpretation and universal application of statutes and codes. Perry Keller, *Sources of Order in Chinese Law*, 42 AM. J. COMP. L. 711, 714-715 (1994). Rather, it is applied in a broader philosophical and moral context. *Id.* "Chinese society has in many respects held to this contextualist approach to law. There continues to be a widely held belief that the application of positive law should be subject to extra legal considerations, such as the relationship and circumstances of the parties and the demands of commonly held standards of justice." *Id.* at 115.

252. Cheng & Rosett, *supra* note 49, at 157.

253. *Id.* at 158-59.

[of moral harmony] and destroys the possibility of a truly virtuous human life."²⁵⁴ Rather, business people in the PRC have relied on a network of personal relationships to provide social sanctions for the breach of agreements.²⁵⁵ The populace's lack of an attitude of legality is a huge obstacle to achieving the rule of law and, because of its deep roots in Chinese culture, not one that can be easily overcome. "[T]he health and strength of the rule of law does not ultimately depend on the efforts of lawyers, judges or police, but on the attitudes of the people."²⁵⁶

Some scholars, however, assert that the application of the other ingredients to the economic development of the PRC could encourage and nurture an attitude of legality.²⁵⁷ The context of international business makes the traditional Chinese reliance upon a network of relationships to enforce agreements less effective. In this context, where the parties to a contract are often "strangers," the connections and relationships are not present to provide a social sanction for breach of an agreement. A legal system of contractual enforcement is required to provide the security necessary to promote commercial transactions among strangers.²⁵⁸ The hope is that exposure to the advantages of a legal system of contractual enforcement will help to promote an

254. As Cheng & Rosett describe:

The rules are stultifying, lead away from moral sensitivity, and cause people to focus on how they can get away with as little commitment to the spirit behind the law as possible. Following closely in the wake of the formal law, one always finds people chiseling around the edges, looking for loopholes, and hypocrites, who are out of touch with the moral spirit of their behavior. Not far away are sure to dwell large bands of pettifogging lawyers giving tax advice, teaching people how to make black seem white, and generally justifying the failure to honor obvious obligations.

Id. at 159 (footnote omitted).

255. *Id.* at 160-61.

256. WALKER, *supra* note 166, at 41.

257. "A vibrant, growing economy guided by law could enhance the 'rule of law' consciousness of the Chinese people, as benefits of legal guidance (instead of administrative fiat) lead to economic development unachievable in socialist command economies." Feinerman, *supra* note 37, at 75.

258. Contract law provides additional sanctions for performance and compliance through legal enforcement that offers strangers greater hope of being able to enforce obligations. To the extent that contract law can deliver on this hope, it supports transactions between strangers and thus encourages the expansion of markets. There will always be advantages to playing on one's home turf, just as there will be costs associated with straying far from home. Nonetheless, the potential of legal enforcement, designed to provide compensation for disappointed expectations through institutions that can put money for damages in the injured party's pocket, can reduce the 'home court advantage.'

Cheng & Rosett, *supra* note 49, at 187.

attitude of legality among those involved in transactions with foreign enterprises.²⁵⁹

2. Government Above the Law

Some scholars assert that the government as well as the populace lacks an attitude of legality. These scholars insist that the PRC's government is not "under the law," but is still using it to promote the state's plan.²⁶⁰ As a result, the principles of legal organization necessary in a society governed by the rule of law are constantly being violated. For example, the Constitution has been changed several times, implicating the principle of certainty.²⁶¹ Several instances of arbitrary enforcement have been reported.²⁶² In short, these scholars assert that the principle of government under law, the purpose of which is to protect the individual from the sovereign—one of the major goals of the rule of law—is not observed in the PRC.

In contrast, other scholars argue that recent political reforms indicate that the PRC still has a chance of realizing the rule of law. First, the PRC's struggle to achieve the rule of law was motivated largely by the excesses of the cultural revolution.²⁶³ Because the government initiated the reforms, the government is more likely to see them through.²⁶⁴ Second, the PRC has formally endorsed the rule of law.²⁶⁵ Since 1978, Deng proposed,

259. "As people achieve higher living standards and accumulate more wealth, they want a greater say in running their own lives, they want a rule of law, and a system of government which is seen to be fair and equitable." *U.K.'s Thatcher/China -2: Acknowledged Some Improvement*, DOW JONES ASIAN EQUITIES REP., Nov. 14, 1996, at 13:35:00, available in WESTLAW, DJAER Database (quoting Margaret Thatcher's remarks at an international conference).

260. Chinese thinking about law has remained primarily instrumentalist, that is, the recent importance that has been attached to law and legality . . . has not led to an enhanced respect for law as a desirable end in itself. Rather, Chinese leaders concluded that law is an indispensable tool for achieving economic modernization but believe law to be useful and necessary only inasmuch as it promotes that goal.

Feinerman, *supra* note 37, at 71.

261. Cheng & Rosett, *supra* note 49, at 196-97.

262. Professor Keith describes an incident in which Deng's Mercedes-Benz failed to yield to an ambulance, causing an accident for which Deng was not punished. KERR, *supra* note 24, at 220.

263. *Id.* at 67-68.

264. *See id.* at 12.

265. Peng Zhen, author of the PRC's new legal system, stated:

In my view, the party guides the people in formulating the national Constitution and the law, it leads the people in observing and enforcing them, and it must act within the framework of the national Constitution

"To ensure people's democracy, we must strengthen our legal system. Democracy has to be institutionalized and written into law, to make sure that institutions and laws do not change whenever the leadership changes, or whenever leaders change their views or shift the focus of their attention."²⁶⁶ As a result, some scholars believe that the PRC has made "substantive progress" towards achieving the rule of law.²⁶⁷ While recognizing that political arbitrariness still exists,²⁶⁸ these scholars argue that "China has entered an age characterized by the rule of law."²⁶⁹

3. The Impact of Market Forces

In discussing whether the PRC's government is under or over the law in the context of administering Sino-foreign economic transactions, there is one additional factor that must be addressed: the power of market forces. Under Professor Walker's paradigm, a society need not be organized according to liberal democratic principles to adhere to the rule of law.²⁷⁰ For example, Islamic law achieved one of the major goals of the rule of law—protecting society from the state—by dividing the social world into two halves. One half was governed by the bureaucratic law of the state.²⁷¹ The other half was governed by

and the law. Otherwise, there will be no socialist democracy or law to speak of in China.

Id. at 13 (footnote omitted).

266. DENG, *supra* note 57, at 157-58.

267. "The rule of law has yet to be established in China . . . [but] for more than a decade China has become deeply involved in a qualitative process of legal change rooted in the domestic necessities of the changing society and politics." *Id.* at 5.

268. "Despite the events of 1989 and the fact that the current system is still plagued by political arbitrariness, there will be no return to the Maoist style of lawlessness." CARLOS WING-HUNG LO, CHINA'S LEGAL AWAKENING 323 (1995) (footnote omitted).

269. *Id.*

270. See discussion *supra* Part V.

271. The state creates bureaucratic law through the specific rules it establishes and enforces. ROBERTO M. UNGER, LAW IN MODERN SOCIETY 50 (1976). Bureaucratic law does not implicate the rule of law because it does not embrace the aims of generality and uniformity in adjudication. *Id.* at 53. Under a system governed by bureaucratic law, the functions of legislation, administration, and adjudication are all in the hands of the bureaucracy. *Id.* at 53-54. In legal systems characterized by the rule of law, "[a]dministration [is] separated from legislation to ensure generality; adjudication [is] distinguished from administration to safeguard uniformity." *Id.* at 54.

customary standards²⁷² and by a body of sacred law.²⁷³ The latter half was, for the most part, beyond the state's control.²⁷⁴

In contrast, scholars argue that there is no similar check on the state's power in the PRC and that the state is above the law.²⁷⁵ Consequently, the rule of law can never be achieved under the current system of government. In strictly domestic matters, that assertion appears valid.²⁷⁶ However, in the context of Sino-foreign economic transactions, there is an additional check on the government's power: market forces. The government perceives foreign capital, technology, and trade as crucial elements in achieving the PRC's long-range economic goals.²⁷⁷ Arbitrary enforcement of foreign economic contracts increases the risk of doing business with and in the PRC.²⁷⁸ If the PRC acts too arbitrarily, the international business community will respond to the increased risk by reducing its interaction with China, reducing the PRC's access to foreign capital, technology, and trade. Consequently, the PRC's government has an incentive to act according to the rule of law.²⁷⁹ If that incentive is great enough to cause the PRC's government to adhere to Professor Walker's principles of legal organization in letter and spirit, then who is to say that foreign economic contracts are not governed by the rule of law?

272. Customary law is the "recurring mode of interaction among individuals and groups, together with the more or less explicit acknowledgment by these groups and individuals that such patterns of interaction produce reciprocal expectations of conduct that ought to be satisfied." *Id.* at 49. Customary law, though influenced by the state, retains its own identity and inertia. *Id.*

273. The sacred law was governed by theological precepts and could not be influenced by the state. *Id.* at 51.

274. *Id.* at 52. Unger argues that ancient Islamic law was not representative of the rule of law because the functions of legislation, administration, and adjudication were not sufficiently separated. *Id.* at 119. Rather the state and the religious elite performed these functions simultaneously within their own spheres. *Id.*

275. In China, unlike other societies, "no important body of sacred precepts [has] ever eluded governmental control." *Id.* at 52.

276. This present impotence of the rule in domestic affairs is evidenced by allegations of human rights abuses and the ease with which contracts can be avoided under the ECL compared to the FECL. See discussion *supra* Part III.B.

277. See discussion *supra* Part III.A.2.

278. The rule of law enables individuals to efficiently order their affairs by transferring risk to the party that is better able to bear it. See discussion *supra* Part II.

279. While market forces may give the PRC's government an incentive to act according to the rule of law, these forces do not instill an attitude of legality within the Chinese people. However, Professor Feinerman has suggested that a "vibrant, growing economy guided by law could enhance the 'rule of law' consciousness of the Chinese people as benefits of legal guidance (instead of administrative fiat) lead to economic development unachievable in socialist command economies." Feinerman *supra* note 37, at 75.

VIII. CONCLUSION

To attract foreign investment, the PRC bifurcated its contract law. It created the FECL to resolve Sino-foreign disputes and modeled it after Western contract law, while leaving the contract law that was used to resolve domestic disputes subject to a more instrumentalist view of the role of law. However, providing a code based on the rule of law is insufficient for the implementation of the rule of law. The rule of law requires legal institutions to support it. By creating separate foreign economic courts, the PRC could extend the concept of bifurcation to the institutions that support the rule of law. In the process, the PRC could strengthen the ability of these institutions to enforce the rule of law without dramatically altering the rest of the legal system or the system of governance.

By making structural changes, the PRC's government could finish the job of isolating the governance of Sino-foreign contracts from the rest of the legal system. This isolation, plus the check provided by market forces against arbitrary action by the PRC's government, could lay the foundation for the operation of the rule of law in contractual relationships between Chinese and foreign enterprises without changing the PRC's system of governance. The question remains: is the PRC motivated to make these changes?

Key to the PRC's motivation to act according to the rule of law is its economic plan calling for foreign investment. First, the PRC has to believe that changes are necessary to support the economic plan. That is, that changes are necessary to continue or increase foreign economic interaction. However, as previously discussed, the PRC's economy is booming. Given its current economic successes, the PRC has little incentive to make any additional changes either because the rule of law is not as important to the international business community as the headlines would lead us to believe or because arbitrary contractual enforcement is not as widespread as these same headlines suggest. On the other hand, the enforcement of Sino-foreign contracts according to the rule of law could lead to even more foreign investment and even greater prosperity for the PRC.²⁸⁰ Further, the PRC is still not a member of the World Trade Organization. Hence, there is some incentive for the PRC to improve its method of enforcing Sino-foreign contracts to support its economic plan.

Second, the PRC's government has to be willing to adhere to the plan. Certainly, because of the success of economic reforms,

280. Cheng & Rosett, *supra* note 49, at 190.

the government has an incentive to adhere to continue economic reform. However, it is speculated that economic development will lead the people to demand the extension of the rule of law throughout the legal system. One Chinese scholar notes, "[R]eformers in communist systems generally find it 'much easier to part with economic Stalinism than with political Leninism.'"²⁸¹ Domestic political unrest caused by contact with the West could cause the PRC's government to slow the pace of economic reform despite its successes and thus reduce the incentive to make changes in the legal system.

A clue as to the PRC's ability to isolate foreign economic contracts from the rest of its legal system and its motivation to do so may be found in the PRC's treatment of Hong Kong after reversion. In Hong Kong, the PRC has been presented with a perfect laboratory to test its economic reforms. It is already isolated from mainland China. It has a successful, well-developed economic system and a Western-friendly legal system for resolving contractual disputes. The extent to which the PRC is able and willing to leave that legal system intact may be the extent to which the PRC's government will be willing to adhere to its economic plan and thus promote the rule of law.

Even if the PRC's government is committed to resolving Sino-foreign disputes according to the rule of law, it is no guarantee that the rule of law can be implemented in the PRC, even in the limited context of the FECL. As Professor Walker noted, the rule of law requires that the populace have the attitude of legality and that the law converge with social values because the institutions that implement the rule of law can be no more effective than the individuals that comprise them. The instrumentalist conception of the role of law in the PRC is deeply rooted in cultural traditions. While market forces may provide individuals with a strong incentive to adopt the rule of law, these forces will not overcome centuries of Chinese legal thought overnight.

Further, applying the rule of law only in the context of the FECL requires not only that the contract law and the institutions that administer it be bifurcated, but that the populace bifurcate its view about the role of law as well. To develop an attitude of legality, the law must converge with social values. To develop an attitude of legality in the context of the FECL, the populace must accept the rule of law as the appropriate role for law in that context. For the populace to accept the rule of law, market forces

281. Richard Baum, *Modernization and Legal Reform in Post-Mao China: The Rebirth of Socialist Legality*, 19 *STUD. IN COMP. COMMUNISM*, 69, 103 (1986) (quoting Stuart R. Schram, "Economics in Command?" *Ideology and Policy Since the Third Plenum, 1978-84*, *CHINA Q.* 461 (Sept. 1984)).

would have to overcome centuries of Chinese legal thought. It seems unrealistic to suggest that, if the populace identifies the rule of law as the appropriate role of law in one arena, it would not be identified as appropriate in other arenas as well. Once identified as the appropriate role of law in other arenas, it seems likely that there would be a popular movement toward the rule of law in those arenas. Consequently, it seems unlikely that the bifurcation of the PRC's contract law will allow the PRC to truly implement the rule of law with respect to the FECL and still maintain the current system of government. Even if the PRC is able to effectively implement the rule of law in the context of the FECL prior to any political change, it seems that political change must surely follow.

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