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FUNDAMENTAL PRINCIPLES OF CHINA'S CONTRACT LAW

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I. INTRODUCTION

On March 15, 1999, the Contract Law of the People's Republic of China[1] was adopted by the Second Session of the Ninth National People's Congress (NPC) and scheduled to take effect on October 1, 1999. The Contract Law's promulgation constitutes not only a major development of China's contract law, but also an important step in China's enactment of its much-awaited Civil Code (*minfa dian*).[2] The Contract Law provides general provisions (entitled *zongze* in Chapters 1-8 in the Contract Law) for governing all types of contractual relationships,[3] as well as particular provisions (entitled *fenze* in Chapters 9-23) for further regulation of 15

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1. Zhonghua Renmin Gongheguo Hetong Fa [Contract Law of the People's Republic of China] [hereinafter Contract Law]. For the full text of the Contract Law, as well as an English translation thereof, *see* CCH, *China Laws for Foreign Business - Business Regulation*, Vol. 1,¶5-650.

2. The Civil Code is currently scheduled to be completed by the year 2010. *See* discussion *infra* Part II, Section D.

3. The few exceptions are contracts or agreements involving the parties' civil status or relationship, such as marriage, adoption and guardianship, which are to be governed by other relevant laws. *See* Contract Law, *supra* note 1, art. 2.

4. These categories include, for example, sales contracts, contracts on the supply of electricity, water, gas or heat, gift contracts, loan contracts, and so on. Those not enumerated are to be governed by the general provisions (*zongze*) and may be dealt with by reference and analogy to (*canzhao*) the particular provisions (*fenze*) or other laws. *See id.*, art.124.

particular categories of contracts, respectively.[4] As the statute that deals specifically with contracts, the Contract Law can be expected to play a crucial role in regulating China's burgeoning market economy and in contributing to China's further legal development.

This Article attempts to discuss some of the fundamental guiding principles of the Contract Law. There are three major principles/policies, namely, those of freedom of contract (*hetong ziyou*), good faith (*chengxin*), and the fostering of transactions (*guli jiaoyi*), that have been conscientiously followed by the law's drafters[5] and that have been essentially embodied in the law's final formulation. By examining major provisions of the Contract Law that embody these three fundamental principles, respectively, we hope to elucidate the main spirit of the Contract Law as well as its general doctrinal structure. For ease of presentation and for want of space, we devote our primary attention to the general provisions (*zongze*), although particular provisions (*fenze*) are occasionally touched upon where relevant.

To provide some necessary background to our discussion, Part II of this Article briefly examines major reasons for the promulgation of the Contract Law and the previous contract laws it is intended to supercede. Parts III, IV and V are then devoted to elucidating the Contract Law's three fundamental principles, viz., freedom of contract, good faith and the fostering of transactions, respectively. In these sections, we attempt to identify major provisions of the Contract Law that reflect these principles and explain how these principles apply at various stages of a contractual relationship. Part VI offers our brief concluding remarks.

II. THE NECESSITY OF THE CONTRACT LAW

The Contract Law unifies and improves upon China's three previous contract laws, namely, the Economic Contract Law,[6] the Foreign

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5. For a discussion of the Contract Law's drafting process, see Professor Jiang Ping, *Drafting the Uniform Contract Law in China*, 10 Colum. J. Asian L. 245, 245 (1996).

6. Zhonghua Renmin Gongheguo Jingji Hetong Fa [Economic Contract Law of the People's Republic of China] (adopted December 13, 1981, implemented July 1, 1982) [hereinafter Economic Contract Law]. CCH, *China Laws for Foreign Business - Business Regulation*, Vol. 1, ¶5-550

Economic Contract Law,[7] and the Technology Contract Law.[8] By superceding the previous contract laws,[9] the Contract Law seeks to establish a more advanced, systematic, and comprehensive contract law to better suit the particular needs of China's transitional economy. Specifically, the Contract Law has been necessitated by the following major problems with the previous contract laws:

A. The Problematic Notion of "Economic Contract"

China's previous contract laws, especially the Economic Contract Law and the Foreign Economic Contract Law, espoused a problematic notion of contract, that of "economic contract" (*jingji hetong*). Originated in the former Soviet Union (USSR), this concept has figured prominently in USSR's economic law regime. In China, the concept of economic contract was adopted for the first time in 1956.[10] With the promulgation of the Economic Contract Law in 1981, the concept was officially adopted by the Chinese legislature. Many scholars have held that economic contracts belong to the field of economic law, while non-economic contracts (i.e., civil contracts; *minshi hetong*) belong to civil law. In connection with the distinction between economic and non-economic contracts, there has been a division of economic courts (*jingji ting*) and civil courts (*minshi ting*) within each of China's people's court (*remin fayuan*). The economic courts have been in charge of handling economic disputes, while the civil courts have been responsible for hearing non-economic, civil cases.

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7. Zhonghua Renmin Gongheguo Shewai Jingji Hetong Fa [Foreign Economic Contract Law of the People's Republic of China] (adopted March 21, 1985, effective July 1, 1985) [hereinafter Foreign Economic Contract Law]. CCH, *China Laws for Foreign Business - Business Regulation*, Vol. 1, ¶5-550.

8. Zhonghua Renmin Gongheguo Jishu Hetong Fa [Technology Contract Law of the People's Republic of China] (adopted June 23, 1987, effective November 1, 1987) [hereinafter Technology Contract Law]. CCH, *China Laws for Foreign Business - Business Regulation*, Vol. 1, ¶5-577

9. When it took effect recently on October 1, 1999, the Contract Law according to its Article 428 simultaneously repealed the Economic Contract Law, the Foreign Economic Contract Law, and the Technology Contract Law. *See* Contract Law, *supra* note 1, art. 428.

10. *See* Shangye Bu Difang Gongye Bu dui Muqian Youguan Gongshang Jihua Xianjie Guance Jingji Hetong zhong Ruogan Wenti Guiding de Lianhe Tongzhi [the Ministries of Commerce and Regional Industry Joint Notice on Regulations on Certain Current Questions on Linking up with and Implementing Economic Contracts in Industrial and Commercial Plans], issued in 1956 [hereinafter Joint Notice]. Issued by ministries under the State Council, the joint notice thus was an administrative regulation [*xingzheng faguī*] or rule [*guizhang*] but not a law proper [*falū*], which can only be promulgated by the legislature – i.e., the NPC and its Standing Committee. *Cf. infra* note 25 and accompanying text.

The concept of economic contract is seriously imprecise and of little use in practice. According to the Economic Contract Law, an economic contract is made between legal persons for the pursuit of a certain economic purpose.[11] This definition, however, does not distinguish the so-called economic contracts from other types of contracts, because in entering a contract the parties almost always have some economic purpose in mind and thus most, if not all, contracts have an economic dimension. As necessitated by the notion of economic contract, all particular categories of contract were divided into economic vis-a-vis civil contracts, to which different rules were to apply. Thus, for example, sales contracts (*maimai hetong*) were divided into "purchase and marketing" (*gouxiao*) and "general sales" (*yiban maimai*) contracts, storage contracts (*baoguan hetong*) into "warehouse storage" (*cangcu baoguan*) and "non-warehouse storage" (*fei cangcu baoguan*) contracts, and so on. In practice, judges often found it difficult to make such distinctions and to apply different rules to contracts based on these distinctions.

To be sure, some unique transactions in the marketplace may indeed give rise to contracts that are markedly different from other contracts. Nonetheless, there are important common grounds among all contracts, economic and non-economic alike. For instance, in forming any contract, the parties must follow general principles such as voluntariness, fairness and good faith; contract performance must be in accordance with terms of the contract and such principles as good faith; breach of contract must entail liability for damages, and so on. These common grounds call for the unification of China's previous contract laws and have formed the basis of the general provisions in the Contract Law. To the extent that particular types of contracts may have their unique features, they can be adequately addressed with the secondary, specific provisions relating to particular types of contracts in the Contract Law.[12]

The division of economic and civil contracts and of their respective sets of rules, in addition to being inherently dubious, also failed to meet the needs of China's developing market economy. A market economy calls for a uniform market, one that is open on equal terms to all types of enterprises, organizations, and individuals. However, the three previous

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11. Economic Contract Law, *supra* note 6, art. 2. A legal person is an organization that can independently bear civil rights and duties. *See* Article 36, Zhonghua Renmin Gongheguo Minfa Tongze (General Principles of Civil Law of the People's Republic of China) (adopted April 12, 1986, effective January 1, 1987) [hereinafter GENERAL PRINCIPLES OF CIVIL LAW or GPCL].

12. *Cf. supra* note 4.

contract laws applied only to economic contracts, which by definition existed only between legal persons (*faren*), not natural individuals (*ziranren*).[13] On the other hand, civil contracts were between natural individuals only.[14] The dichotomy between economic and civil contracts was thus unfavorable to developing a uniform market in China and to providing a uniform contract law to all types of parties and transactions.

Although the Economic Contract Law underwent a significant revision in 1993,[15] that revision did not eliminate the need for a uniform contract law. A chief reason is that the Revised Economic Contract Law still retained the concept of economic contract. In addition, the revision of the Economic Contract Law failed to successfully coordinate the interrelationship among the three previous contract laws and between these laws and the General Principles of Civil Law,[16] as will be discussed in greater detail below.

B. Contradictions and Redundancies among the Previous Contract Laws

There were many contradictions and redundancies among the previous contract laws. For instance, modeled more closely on Western contract laws, the Foreign Economic Contract Law accorded the contracting parties greater freedom of contract than did the Economic Contract Law.[17] Article 17 of the Foreign Economic Contract Law stipulated, for example, that "[a] party may temporarily suspend its performance of the contract if it has conclusive evidence that the other party is unable to perform." This stipulation, however, was absent from the Economic Contract Law, which provided a mandatory rule for specific performance.[18]

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13. *See supra* note 11 and accompanying text. As distinguished from legal persons, natural persons refer to individual citizens (*gongmin*) in general. *See* GPCL, *supra* note 11, Chapter II.

14. *Cf.* Liu Ruifu (ed.), HETONGFA JIAOCHENG [A TEXTBOOK ON CONTRACT LAW], 25 (Zhongguo Zhengfa Daxue Chubanshe [The Publishing House of the China University of Political Science and Law] 1991).

15. *See* Zhonghua Renmin Gongheguo Jingji Hetong Fa [Economic Contract Law of the People's Republic of China] (revised September 2, 1993) [hereinafter REVISED ECONOMIC CONTRACT LAW].

16. *See supra* note 11.

17. *Cf.* Professor Jiang Ping, *supra* note 5, at 246.

18. *See*, Economic Contract Law, *supra* note 6, art. 31; *Cf.* Liu Zhongya (ed.), XIN JINGJI HETONGFA [THE NEW ECONOMIC CONTRACT LAW], 60 (Zhongguo Shenji Chubanshe [China Audits and Statistics Press] 1990).

The Revised Economic Contract Law created some additional discrepancies among the previous contract laws. For example, Article 27 of the Economic Contract Law provided that only where performance of an economic contract was rendered unnecessary by one party's breach, might the other party terminate the contract. To accord greater respect for a party's right of termination upon the other party's breach, the Revised Economic Contract Law abandoned this provision. However, the Technology Contract Law still followed Article 27 of the Economic Contract Law in stipulating that a party could only terminate a technology contract where its performance was rendered unnecessary or impossible by the other party's breach.[19] Thus there existed an obvious contradiction between the Revised Economic Contract Law, on the one hand, and the Technology Contract Law, on the other.

As they contradicted and duplicated one another, the previous contract laws also failed to cover certain common situations. For instance, the Economic Contract Law governed economic contracts only, leaving non-economic contracts to be governed by no particular statute. (This was so although the economic-noneconomic distinction was unclear and imprecise). In addition, with the Foreign Economic Contract Law governing economic contracts involving foreign parties[20] and the Economic Contract Law governing domestic contracts only, there was no legal basis for deciding disputes concerning non-economic contracts involving foreign parties. For example, when a foreign citizen rented a house from a Chinese citizen, thus giving rise to a so-called non-economic contract, the previous contract law provided no clear guidance on which statute should govern the contract in question.

Similarly, because the Technology Contract Law applied to domestic technology contracts only[21] and the Foreign Economic Contract Law did not apply to technology contracts involving foreign parties,[22] foreign-related technology contracts were left outside the realm of the former contract laws.[23]

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19. Technology Contract Law, *supra* note 8, art. 24.
20. *See* Foreign Economic Contract Law, *supra* note 7, art. 2.
21. *See* Technology Contract Law, *supra* note 8, art. 2.
22. *Cf.* Foreign Economic Contract Law, *supra* note 7, art. 2.
23. The Revised Economic Contract Law provided that foreign-related technology contracts were to be governed by the Technology Contract Law. Revised Economic Contract Law, *supra* note 15, art. 46. This temporary make-do was problematic, however, because the Technology Contract Law was generally more restrictive than the Foreign Economic Contract Law. *Cf. supra* note 19 and accompanying text. It was also awkward because Article 2 of the Technology Contract Law

There also existed inconsistencies between the three contract laws, on the one hand, and the General Principles of Civil Law ("GPCL"), on the other. For instance, the GPCL stipulates that, "civil acts should follow the principles of voluntariness, fairness, equal compensation, and good faith."[24] By contrast, Article 5 of the Economic Contract Law provided that, "[i]n forming economic contracts, [parties] must follow the principles of equality and mutual benefit, consultation and agreement, and equal compensation," whereas Article 3 of the Foreign Economic Contract Law provided that, "contract formation should follow the principles of equality and mutual benefit, and consultation and agreement." Neither of the two contract laws mentioned the principle of good faith, as does the GPCL.

According to Professor Liang Huixing, such problems with China's previous contract law were primarily attributable to the executive branch's undue influence on legislation.[25] Many laws as well as administrative regulations (*fagui*) and rules (*guizhang*) have been drafted by various ministries and commissions under the State Council, who often have been too confined by their own perspectives to take account of the general legal structure.[26] It is clear, therefore, that only by the legislature's drafting an overarching Contract Law to replace the three previous contract laws can the previous contract laws be unified and improved.

C. *The Lack of Basic Contract Rules in the Previous Contract Laws*

Since the promulgation of the Economic Contract Law in 1981, China saw the production of several major laws and regulations in the field of contract. Despite all of this, however, China always lacked some basic contract rules, such as those on offer and acceptance. As a consequence, such crucial issues as what constitutes an offer or acceptance, what distinguishes an offer from an invitation to deal, and so on, were left to the discretion by individual judges. This created much discrepancy and many similar problems in practice.

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explicitly excluded foreign-related technology contracts from its coverage.

24. GPCL, *supra* note 11, art. 4.

25. Liang Huixing, *Cong Sanzudingli Zouxiang Tongyi De Hetongfa [To advance from the three-pillars/laws system to a unified contract law]*, ZHONGGUO FAXUE [CHINESE JURISPRUDENCE], No. 3, 1995, at 9.

26. *Id.*

Similarly, the previous contract laws lacked any legal rules on pre-contractual liabilities. For instance, as has been quite common in China, prior to the formation of a contract, one party may accidentally or maliciously cause significant damage to the other party. Can the injured party demand compensation in such cases? There was no rule in the previous contract laws that addressed this question and the new Contract Law should provide such a rule.

The lack of such basic rules in China's previous contract law is seriously troublesome if one takes into account the many recent developments in contract law in other legal systems. Since World War II, contract laws in many advanced countries have had tremendous developments as their market economy has experienced further growth. By means of case law or codification, these countries have established many new contract rules to reflect their current market practice.[27] Similarly, there have been substantial changes in international regulations on contracts.[28] In order to further develop its economy and integrate itself into international market, China must learn from the contract legislation in other legal systems and bring its contract law to maturity and modernization.[29]

D. The Contract Law and the Civil Code

In addition to rectifying the problems identified above, the Contract Law is also a part of China's efforts to develop a civil code. China started to design a civil code in the early 1950s. More than 40 years later, however, a civil code still remains a mere wish for Chinese legal scholars. Nonetheless, with the drastic changes in China's social and political life as well as the development of China's market economy, to enact a civil code has now become the consensus of all that are concerned. In order to reach the goal of developing its market economy and that of administering the country according to law (*yifa zhiguo*), the Chinese government has resolved to complete, by the year 2010, a comprehensive, modern legal

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27. *See, e.g.*, American Law Institute, Restatement of the Law Second, Contracts (1981) [hereinafter RESTATEMENT OF CONTRACTS 2d]; American Law Institute and the National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code (1990) [hereinafter UCC].

28. *See, e.g.*, the United Nations Convention on Contracts for the International Sale of Goods (1980) [hereinafter CISG] and the UNIDROIT Principles of International Commercial Contracts (1994) [hereinafter UNIDROIT Principles].

29. *Cf.* Liang Huixing, *supra* note 25.

system. The promulgation of the civil code will mark the eventual establishment of this legal system.

However, the drafting of a civil code is a tremendous, complicated project that can only be undertaken step by step. The promulgation of the Contract Law is a necessary, major step in producing the civil code. Upon the promulgation of the Contract Law, legislation of the law on obligation and on contracts has been essentially completed; in the future it can be directly incorporated into the civil code.

When drafting the Contract Law, there were two differing opinions among the drafters and legal scholars as to its contents. Some scholars were of the opinion that the law should include general provisions and, whenever possible, particular provisions that will govern various specific types of contracts. Other scholars held that, in order to expedite the law's promulgation, we should first promulgate the general provisions and, as does the UCC, provide particular rules only on sales contracts but not any other types of contracts. The legislature has adopted -- correctly in our opinion -- the first position. This is because the previous contract laws provided rules on many particular types of contracts. To unify and supercede the previous laws, the Contract Law must necessarily provide for those particular types of contracts as well.

III. THE PRINCIPLE OF FREEDOM OF CONTRACT

The fundamental principles of a contract law represent the law's essence and spirit. As the law's guiding principles, they are the starting point for drafting, interpreting, implementing, as well as for studying the law. In practice, such principles may oftentimes be employed to guide or inform, or even serve as the legal basis for, the resolution of various contractual disputes.[30] We believe that the Contract Law has been primarily influenced by three fundamental principles: freedom of contract, good faith, and the fostering of transactions. This section focuses on explicating the principle of freedom of contract, whereas the following two sections are devoted to the principles of good faith and the fostering of transactions, respectively.

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30. *Cf.* Yu Liang, *Hetong Xiaoli De Buchong [Supplementation to the effectiveness of a contract]*, ZHENGFA LUNTAN [POLITICAL SCIENCE AND LAW FORUM], No. 4, 1998, at 75-79.

As a fundamental legal principle, freedom of contract recognizes a contracting party's freedom in choosing the other contracting party, forming a contract, determining the terms and contents of the contract, modifying or terminating the contract, stipulating the remedies for a breach, and so forth. The principle of freedom of contract governs every stage of the contracting process and is in many ways the most crucial of all contract law principles.

In drafting the Contract Law, there existed differing opinions on whether we should adopt the principle of freedom of contract. Some scholars held that the notion of freedom of contract originated from classical Western contract law models; by the 20th century, however, as nation-states have strengthened their intervention in contracts, this principle has gradually become defunct. China's contract law, so the argument goes, "must follow the new trends in the world's contract law, i.e., to place necessary limitations on freedom of contract in order to realize social public interest and the protection of the weak in society."[31] Another opinion held that the principles of equal consultation (*pingdeng xieshang*), equal compensation (*dengjia youchang*), and so on, have essentially embodied the contents of freedom of contract. Therefore, there is no need in the new Contract Law to stipulate the principle of freedom of contract.

We believe that both of these opinions are incorrect. To be sure, since the beginning of this century, many developed nations have indeed strengthened state intervention in contracts. Nonetheless, freedom of contract remains a fundamental legal principle.[32] In China, the long history of intense centralized planning and the elimination of freedom of contract now calls for an expansion of contractual freedom, rather than its restriction. This is necessary because, although the economic reforms have greatly strengthened various parties' autonomy to engage in economic activities, in reality there still exist many limitations on and deprivations of the parties' freedom of contract.[33]

The principle of freedom of contract must be adopted also because it is needed for the fostering of transactions and for the further development of China's market economy. As Professor Jiang Ping has pointed out, "To

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31. *See, e.g.*, Sun Peng, *Qiyuefa De Xiandai Fazhan [Contemporary development of contract law]*, XIANDAI FAXUE [CONTEMPORARY LEGAL STUDIES], No. 4, 1998.

32. See, e.g., E. ALLAN FARNSWORTH, CONTRACTS, 3rd Edition, (Aspen Law & Business, 1998), §1.7, §1.8.

33. *Cf.* Liang Huixing, *Zhongguo Hetongfa Qicao Guochengzhong De Zhenglundian [Issues in the drafting of China's Contract Law]*, FAXUE [THE SCIENCE OF LAW], No. 2, 1996, at 13-15.

accord parties freedom of action to the greatest extent possible is the common demand by the market economy and the autonomy of the parties' free will."[34] The more developed and widespread the various contractual relationships, the livelier the transactions, and the more dynamic the market economy. Only with a developed market economy and its active transactions can the society's wealth substantially increase. All this will depend on how much freedom of contract the parties will enjoy according to law. Under the current circumstances, China's contract law must thus embrace freedom of contract as its most fundamental principle. This principle will not only substantially improve China's contract law but also, for China's legal system in general, lay down a novel rule-of-the-law precept that fully respects the freedom and rights of enterprises, organizations, and citizens.[35]

To be sure, China's civil law has established the principles of equal consultation and equal compensation.[36] These principles, however, do not amount to and cannot replace freedom of contract. On the one hand, these principles do not express a notion of freedom, but of equality. They are concerned primarily with the relationship between two equal parties and emphasize equality as the relationship's guiding principle. However, the principle of freedom of contract is not limited to the relationship between two parties, but recognizes instead genuine freedom that any contracting party may lawfully enjoy. On the other hand, although these principles are directly applicable to contractual relationships, their scope is not limited to contracts but covers other civil legal acts as well. By contrast, freedom of contract is a particular principle for contracts; it governs contractual relationships but not any other civil legal relationships.

Furthermore, the principles of equal consultation and equal compensation apply primarily to contract formation, whereas freedom of contract not only covers contract formation, but also the contents and form of the contract, the modification and termination of the contract, the transfer of contract, and any other segments of the entire contract process. For the reasons stated above, the principles of equal consultation and equal

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34. Jiang Ping et al., *Shichang Jingji He Yisi Zizhi [Market economy and autonomy by parties' free will]*, FAXUE YANJIU [LEGAL STUDIES], No. 6, 1993, at 20-25.

35. Cf. Liu Hainian et al (eds.), YIFA ZHIGUO, JIANSHE SHEHUI ZHUYI FAZHI GUOJIA [ADMINISTERING THE COUNTRY ACCORDING TO LAW, ESTABLISHING A SOCIALIST COUNTRY UNDER THE RULE OF LAW], 25 (Zhongguo Fazhi Chubanshe, 1996).

36. See, e.g., GPCL, *supra* note 11, art. 4. *Cf.* Revised Economic Contract Law, *supra* note 15, art. 5.

compensation can not, contrary to the opinion of some researchers, replace freedom of contract.

A major reflection of the Contract Law's adoption of freedom of contract -- in spirit if not in the exact words -- is that it has, to the greatest extent possible, limited the mandatory provisions in the previous contract laws and, at the same time, broadened the scope of elective provisions.[37] Generally, under the Contract Law, if the contracting parties have reached an agreement as to matters of their transaction, their agreement shall govern; only where no agreement exists will the law be triggered. For instance, many articles of the Contract Law include the important qualifier "except where the parties have otherwise agreed,"[38] indicating the law's respect for the parties' free will. The Contract Law's affirmation of the principle of freedom of contract is, additionally, reflected in the following respects:

A. Contract Formation

With respect to contract formation, the Contract Law has substantially reduced or eliminated the restrictions by the previous contract laws, regulations and rules on the parties' freedom to form contracts and to select their contractual partners. According to Article 4 of the Contract Law, "[p]arties have the right to voluntarily enter into a contract, no entity or individual may unlawfully interfere[with this right]." It is true that Article 38 of the Contract Law provides that "[w]here the State according to its need issues mandatory plans or state purchasing tasks, the concerned legal persons and other organizations shall form contracts in accordance with their rights and duties as provided in relevant laws and administrative regulations," thus placing some limitation on the parties freedom to form a contract. Nonetheless, because the State currently only imposes mandatory plans in truly exceptional situations, this provision does not seem to significantly restrict the parties' freedom with respect to contract formation.

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37. *Cf.* Liang Huixing, *supra* note 33.

38. See, e.g., Contract Law, *supra* note 1, articles 34 and 79 among the general provisions (*zongze*) and articles 133, 142, 197, 220, 225, etc., among the particular provisions (*fenze*).

B. Contract Validity

The Contract Law respects the parties' freedom in validating their contract and has significantly reduced the government's unnecessary intervention in that area. The Contract Law no longer grants state executive agencies the power to determine the effectiveness of a contract and places serious restraints on their power to supervise and examine (*jiandu jiancha*) contracts.

For example, Article 127 of the Contract Law stipulates that "[w]ithin the scope of their respective authority and responsibilities, departments of the industry and commerce administration and other relevant administrative agencies in charge shall, according to provisions by law and administrative regulations, take charge in supervising and handling any illegal act that, by the means of a contract, harms the state interests and public interests." This article does not provide a cover-all contract management power to executive agencies, as did the previous contract laws,[39] but requires the administrative organs to obey the law and regulations when supervising contracts. More important, this article explicitly limits the scope of contracts to be monitored by administrative organs to those that "harm State interests and public interests."[40] This will help prevent the executive branch from willfully expanding its power to managing contracts to the detriment of the parties' necessary freedom of contract.

C. Terms of a Contract

The Contract Law provides that the terms of a contract are to be decided by the parties through agreement.[41] Although the law lists some terms that are generally included in a contract, such as the parties' names and domiciles, the subject matter of the contract, and the quantity and quality of the goods involved, it does not require that all contracts contain all these terms. The law does not impose uniform provisions on the terms in all types of contracts. The contracting parties enjoy freedom and flexibility in determining what to include in their contract.

By contrast, Article 12 of the Economic Contract Law stipulated that economic contracts were to have five major terms: namely, subject

39. *See, e.g.*, Economic Contract Law, *supra* note 6, art. 51.
40. Contract Law, *supra* note 1, art. 127.
41. *Id.*, art.12.

matter; quantity and quality; price or compensation; the time period, location, and form of performance; and liability for breach of contract. The law's listing of major terms that were to be included in a contract had in practice been easily misunderstood as meaning that absence of any of such terms would entail an invalidation of the contract. The Contract Law has discontinued such provisions from the Economic Contract Law in order to avoid such misunderstandings.

D. Contract Termination

China's previous contract laws recognized that parties might terminate a contract through consultation with each other.[42] They did not recognize, however, that parties might terminate their contract through the exercise of an agreed-upon right of termination. An agreed-upon right of termination is the right to terminate a contract under certain stipulated circumstances; the right is normally assigned to a party as a result of the parties' negotiation. The parties' agreement as to this right may be reached when the contract is formed or it may be reached independently thereafter.

The Contract Law now explicitly recognizes the parties' right to agree upon contract termination and allows the parties to stipulate -- e.g., at the time when the contract is formed -- a right to terminate the contract. After the contract takes effect, if the conditions for terminating the contract are materialized, a party that holds the right of termination shall be allowed to terminate the contract by exercising its agreed-upon termination right.[43]

E. Liability for Breach of Contract

The Contract Law accords substantial respect for a non-breaching party's freedom to choose the form of remedy where the other party breaches. For example, Article 107 of the Contract Law stipulates that "[w]here one party fails to perform its contractual obligations or fails to perform its contractual obligations in accordance with the contract, it shall bear the liability for breach by continuing its performance, taking remedial measures, or paying damages." This provision has essentially abandoned the traditional mandatory rule of specific performance.[44] It allows the non-

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42. See Economic Contract Law, *supra* note 6, art. 27(1); Foreign Economic Contract Law *supra* note 7, art. 31(3); Technology Contract Law, *supra* note 8, art. 23.

43. *See* Contract Law, *supra* note 1, art. 93.

44. See Economic Contract Law, *supra* note 6, art. 31; *Cf.* Liu Zhongya, *supra* note 18, at 60.

breaching party to choose the form of remedy, including liquidated damages, damages, as well as specific performance (excepting special situations where the law recognizes that specific performance is impossible). With regard to the terms of liquidated damages, the Contract Law will generally follow the agreement between the parties. Even where the liquidated damages do not correspond to the damages as determined by law, the liquidated damages are to be deemed valid unless they are determined to be unduly high or low.[45]

It should be pointed out, however, that the freedom of contract as embodied by the Contract Law is relative, not absolute. In order to ensure that China's market economy develops in an orderly fashion, it is necessary for the State to exercise some measure of intervention and control. State invention is appropriate especially where it is needed to ensure that contracts are adequately fair and equal, that they balance the parties' conflicts of interest sufficiently well, that they do not serve the parties' interest to the detriment of the welfare of the state and the society, and so on.

The justification for state intervention in contracts is often summarized in China as the principle of contract justice (*hetong zhengyi*), for it is justice that state intervention is called upon to achieve. There are a number of scholars who believe that contract justice and freedom of contract are the two major principles of contract law, with one principle supplementing and assisting the other. Contract justice can function to counteract the shortcomings of freedom of contract and to supplement its insufficiencies.[46] That the Contract Law has embodied the spirit of contract justice can be seen in Articles 39-41 and Article 53, which impose restrictions on the use of form contracts and on clauses of indemnification.[47]

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45. *See* Contract Law, *supra* note 1, art. 114.

46. *See* Wang Yuanzhi and Feng Jinsheng, *Lun Hetong Zhengyi [On contract justice]*, ZHENGFA LUNTAN [POLITICAL SCIENCE AND LAW FORUM], No. 6, 1996.

47. Article 39 requires the party employing a form contract to alert the other party to the contract's indemnification provisions and to explain these provisions at the other party's request. Article 40, by cross-referencing to Articles 52 and 53, invalidates form contracts that harm the State interest or public interest, or improperly shift liabilities to the other party. Article 41 provides that contract interpretation is to disfavor the party employing a form contract. Article 53 invalidates clauses in a contract that indemnify a party against 1) property damages it causes to the other party by its intentional misconduct or gross negligence and 2) personal injury it causes to the other party.

IV. THE PRINCIPLE OF GOOD FAITH

The principle of good faith (*chengxin*; literally, honesty and trustworthiness) requires parties to a civil act to conduct themselves honorably, to perform their duties in a responsible matter, to avoid abusing their rights, to follow the law and common business practice, and so on. In civil law countries, the principle of good faith is often called the highest guiding principle or the "royal principle"[48] for the law of obligations. Why should the Contract Law recognize and embody the principle of good faith? We believe the major reasons are the following:

A. Norms of Commercial Conduct

The principle of good faith will help to maintain China's traditional mores and commercial ethics. Chinese society has been under the crucial influence of Confucianism and has constantly been holding up the value of good faith. Good faith has not only been one of the general principles for people's everyday conduct but has also been a crucial moral precept in China's commercial practice. By embracing the principle of good faith, the Contract Law is recognizing China's traditional morality and business ethics, which is also consistent with the norms of international commercial practice. With its strong moral force, the principle of good faith can be expected to contribute much to the establishment of a normal transactional order in China.

B. Respect for and Performance of Contract

On a more specific level, the principle of good faith will help to ensure that contracts are respected and performed. Good faith requires that one keep one's word and be trustworthy. Only when parties to a transaction abide by the principle of good faith can their contract be adequately respected and executed. If people take the notion of good faith seriously, even if their contract is deficient in some way, they will endeavor to cure the contract's defects and fulfill their obligations. Conversely, in a situation where the contract is perfectly complete, if the parties do not act in good faith, the contract is unlikely to be faithfully carried out.

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48. *Cf.* MORIDA MITSUO, SAIKENHOU SOURON [A GENERAL INTRODUCTION TO OBLIGATION LAW], 28 (Gakuyou Shobou [Gakuyou Publishing House] 1978)

Therefore, the strengthening of the principle of good faith is a necessary foundation for the establishment of an optimal transactional order for China.

C. *Other Functions of the Principle of Good Faith*

As a fundamental principle underlying the transactional order, the principle of good faith should not only help balance the parties' conflicts of interest during their transaction but also help guide the interpretation of the law and the contract in question. In view of the many social and economic changes occurring in China, many laws and regulations are no longer suitable to the current economic situation. Thus, if we adopt the principle of good faith and enable judges to fill the legal loopholes/vacuums accordingly, this will help to develop and improve China's legal system.[49]

The Contract Law requires the contracting parties to exercise their rights and fulfill their duties in strict accordance with the principle of good faith, not only at the stages of contract formation, performance, modification and termination, but also after the contractual relationship is terminated. The law recognizes that parties to a transaction should act in good faith at every stage of their transaction. Only with good faith can they be made to follow not only commercial ethics, but also their contract, thus helping to develop a normal order for transactions.

1. Good faith at the stage of contract formation

At the stage of contract formation, although the contract has not yet been formed, the parties have already been in contact and may have even reached some preliminary agreement. They therefore should, according to the principle of good faith, observe some necessary ancillary (*fusui*) duties. In accordance with the principle of good faith, contracting parties owe to each other the following duties when forming their contract:

(a) The duty of loyalty in forming the contract.

The parties should engage in the making of their contract out of good will. They shall not, under the disguise of forming a contract,

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49. *Cf.* Liang Huixing, *supra* note 33.

viciously conduct negotiations with the other party in order to cause losses to the other party. For example, they are not to negotiate with the other party in order to prevent that party from forming a contract with a third party;[50]

(b) The duty of honesty and non-deception.

The parties should truthfully state to each other the defects and qualities of their products and may not otherwise seek to deceive the other party. The parties should also, at the same time, state to each other certain important facts, such as their financial situation, their abilities (or the lack thereof) to perform, and so on. On the whole, they should be faithful to the facts and should not make any false statements. If they intentionally conceal important facts or provide false information in connection with contract formation, thus causing losses to the other party, they must be liable for damages;[51]

(c) The duty to keep promises.

During their negotiations, parties should strictly keep their promises. When a party sends out an offer, it should be prepared to be bound by the offer. After the offer reaches the offeree and the offeree reasonably relies on the offer, if the offeror by canceling its offer causes damage to the offeree, the offeror should bear liability for such damage. If the contract is to be formed by telegram, facsimile or other similar means, and one party demands the signing of a confirmation letter before the contract is formed, the other party should agree.[52] But where the parties have formed a preliminary agreement or where one party has made a promise that has caused reasonable reliance by the other party, if the party who requests the signing of a confirmation letter eventually fails to accept the offer, it should, by implication, pay for the other party's reliance damages;

50. Contract Law, *supra* note 1, art. 42.
51. *Id.*
52. *See* Contract Law, *supra* note 1, art. 33.

(d) The duty of confidentiality.

The contracting parties must not reveal or improperly use commercial secrets they have learned during the process of contract formation, whether or not the contract is actually formed or becomes effective. Otherwise, they shall pay damages to the injured party for its losses resulting therefrom.[53]

2. Good faith after contract formation and before contract performance

After the contract is formed but performance has not yet begun, parties should, according to the principle of good faith, strictly keep their promises and diligently prepare for their performance of the contract. If, prior to its performance, one party suffers serious losses from its ill-management/operation or encounters other adverse situations as specified by law, the other party may temporarily cease its own performance and demand insurance for performance by the first party. However, in thus exercising its right of termination, the other party should strictly follow the spirit of good faith as well as conditions stipulated by law. It should not, because of temporary or non-serious difficulties restricting the other party's ability to pay, use that as a pretext for terminating its own performance. If its failure to thus follow the principle of good faith causes losses to the other party, it shall pay damages for such losses.[54]

If, without the reasons as outlined above, one party during this period explicitly informs the other party or manifests by its conduct that it will not perform the contract, the other party may demand that it bear liability for breach of contract before the term of the contract expires.[55] But where one party does not signal that it will not perform the contract, or its signaled non-performance has a proper legal excuse, the other party should, in accordance with the principle of good faith, refrain from terminating the contract.[56]

53. *Id.*, art. 43.
54. *See id.*, art. 68.
55. *Cf. id.*, art.108.
56. *Cf. id.*

3. Good faith in contract performance

Contract performance should strictly follow the principle of good faith. When performing their contract, parties should observe various ancillary duties created by the principle of good faith, in addition to their duties as stipulated by law and the contract. As has been discussed above,[57] such ancillary duties include the duty of loyalty, the duty to disclose defects and to notify the other party of important situations, duty to cooperate with and assist each other, the duty to convey instructions for use, and so on.

As to duties that are stipulated by the law or the contract, if they are unclear, insufficient or lacking, the principle of good faith requires that parties perform their duties in good faith. For instance, if a contract does not specify any quality requirements for its subject matter, the obligor should not, contrary to the principle of good faith, intentionally select and deliver goods and services that are of inferior quality.[58] If the contract does not specify the time of performance, when the obligor offers to perform, it should according to the precept of good faith allow the obligee some necessary, reasonable period of time for preparation. If the contract stipulates the time limits for its performance, the obligor in selecting the actual time of performance must follow the principle of good faith as well. In this situation, if the obligor has a proper reason to perform before the deadline and this advance performance will not cause any damage to the obligee, the obligee should accept the obligor's performance unless he has a proper reason not to. One such reason would be that this advance performance would somehow harm or seriously inconvenience the obligee.

4. Good faith in terminating a contract

In comparison with China's previous contract laws, the Contract Law provides unequivocal limitations on how a contract is to be terminated. For example, it provides that only where one party's delay of its performance or some other breaching act frustrates the purpose of the contract, may the contract be terminated.[59] In general, termination of a contract must follow the principle of good faith. For instance, where the

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57. *See supra* discussion Part IV, Section C.1.

58. Wang Jiafu, ed., MINFA ZHAIQUAN [OBLIGATION RIGHTS IN THE CIVIL LAW], 393 (Falü Chubanshe [Publishing House of Law] 1991).

59. *Cf.* Contract Law, *supra* note 1, art. 94.

goods delivered by one party are deficient but these goods comprise but an insignificant part of the entire order, the other party generally should not terminate the contract on that basis alone. Similarly, in the case of a long-term contract, should either party decide to terminate the contract according to conditions specified therein, it should notify the other party as far in advance as practicable, so that the other party may have enough time to cope with the termination.

5. Duties of confidentiality and loyalty after the contract is terminated

Following contract termination, the contracting parties no longer owe each other any contractual obligations. They should, however, in accordance with the principle of good faith, bear certain necessary ancillary duties, the most important of which are the duties of confidentiality and loyalty. Such duties are thus called post-contractual duties (*hou qiyue yiwu*) as are imposed by the principle of good faith. A number of scholars have argued that imposition of these duties is unjustified. According to them, once the contractual relationship is terminated, there will no longer exist any relationship between the contracting parties as regards that contract. Neither party should bear any contractual duty to the other, otherwise we would be imposing on parties duties they have not contracted for.[60]

This opinion apparently has a kernel of truth. In general, contractual duties are to be terminated when the contract is ended and neither party should bear any further contractual duty to the other party unless the contract stipulates otherwise. Under certain circumstances, however, although the contractual relationship is terminated, it is necessary to impose some post-contractual duties under the principle of good faith. For example, suppose A hires B for a number of years. At the end of B's term, A does not renew B's employment contract because he has not been satisfied by B's performance. B goes to work for A's competitor C and divulges A's operational secrets to C, thus causing serious damage to A. Because the secrets do not come under the protection of patent law nor do they qualify as privacy, A will not be able to sue B except on the basis of B's post-contractual duties to A. To deal with cases such as in the

60. *See* Zhang Jing, ed., ZHONGHUA RENMIN GONGHEGUO HETONGFA SHIYI (AN INTERPRETATION OF THE CONTRACT LAW OF THE PEOPLE'S REPUBLIC OF CHINA) 159(Zhongguo Fangzheng Chubanshe [China Fangzheng Press] 1999).

hypothetical above, Article 92 of the Contract Law thus recognizes a series of post-contractual duties under the principle of good faith.[61]

6. Good faith in contract interpretation

In practice, the language used by parties in their contract may be imprecise or ambiguous, and the contract may fail explicitly to stipulate the parties' rights and duties. Such problems may prevent the contract from being correctly performed and thus engender disputes. In these situations, the court or arbitration tribunal should according to the law invoke the principle of good faith, taking into account relevant factors (such as the nature and purpose of the contract, the business customs at the location of the contract's formation, and so on), so as to arrive at the parties' true intention and meaning, and thus correctly interpret the contract and the parties' respective rights and duties.

In interpreting a contract, the court or arbitration tribunal should, in accordance with the principle of good faith, balance the parties' interests and determine the terms of the contract fairly and reasonably. For example, in case of a gratuitous contract (*zengyu hetong*), the interpretation should favor a less burdensome obligation by the obligor, whereas in a contract for consideration, the interpretation should generally be equitable to both parties. That contract interpretation should follow the principle of good faith is explicitly provided for in Article 125 of the Contract Law.

V. THE PRINCIPLE OF FOSTERING TRANSACTIONS

A transaction is an exchange of property and/or other forms of interest between independent entities or individuals in the marketplace. Transactions are expressed as contractual relations and thus are governed by contract law. That the Contract Law has adopted the principle of fostering transactions is reflected not only by the fact that the law regulates transactions, but also by the following:

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61. Article 92 provides that "[u]pon the termination of contractual rights and duties, the parties shall follow the principle of good faith and fulfill duties such as notification, assistance, confidentiality, etc., in accordance with business customs." Contract Law, *supra* note 1, art. 92.

A. *Fostering Transactions in Order to Promote China's Market Economy*

Under a market economy, all transactions are essentially conducted by forming and performing contracts. The market itself consists of transactions, the totality of which in turn constitutes the aggregate market. From this perspective, contractual relationships constitute the most basic legal relationships in a market economy.[62] In order to promote the continuing development of China's market economy, a fundamental objective of the contract law must be to foster and encourage transactions. This is because encouraging parties to engage in transactions is tantamount to encouraging their participation in the market. Only when transactions on the market, under the protection of contract and other related laws, become increasingly numerous and frequent can China's market economy achieve genuine development.

B. *Fostering Transactions in Order to Increase Efficiency and Social Wealth*

Similarly, transactions must be encouraged so that economic efficiency and the overall wealth of society can be increased. This is not only because different entities and individuals can satisfy their needs for different goods or services and their desire to increase their wealth only through transactions, but also because only through freely-negotiated transactions can resources be distributed optimally and utilized most efficiently. According to Professor Wang Weiguo, the value orientations of contract law consist in efficiency, security for transactions, and fairness.[63] The goal of efficiency depends very much on a secure legal environment for voluntary transactions.[64] Voluntary transactions can, through a process similar to bidding, allow resources to go to the party who values them the most. This party can in turn use the resources to produce the greatest value. Thus, although contract law itself can not create social

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62. *See* Liang Huixing, ed., SHEHUI ZHUYI SHICHANG JINGJI GUANLI FALÜ ZHIDU YANJIU [RESEARCHING A LEGAL SYSTEM THAT GOVERNS THE SOCIALIST MARKET ECONOMY], 7 (Zhongguo Zhengfa Daxue Chubanshe [The Publishing House of the China University of Political Science and Law] 1991).

63. Wang Weiguo, *Lun Hetong Wuxiao Zhidu [On the system of invalidating contracts]*, FAXUE YANJIU [LEGAL STUDIES], No. 3, 1995, at 11-24.

64. *Cf. id.*

wealth, it can foster efficient transactions and therefore induce the creation of and increase in social wealth.

C. *Fostering Transactions and the Protection of Freedom of Contract*

The contracting parties' autonomy and free will are the basis of and premise for genuine transactions. Without autonomy and free will, transactions cannot be fair and equitable. Where the parties voluntarily agree to be bound by a contract, and where the contract does not violate the law or public morality, it will violate the parties' autonomy and free will if any third party -- including the State -- forces the parties to terminate their contract. It is clear, therefore, that encouraging transactions and assisting the parties to realize their purpose in forming the contract is in compliance with their free will and the notion of freedom of contract.

It is worth noting that by fostering transactions, we mean primarily the encouraging of lawful transactions. The legality of a contract is a chief premise for the validity of a contract. That is to say, only where the parties' agreement does not violate the state's law and public interest will it be legally enforceable. In situations where the contract violates the law or public interest, the law should not only refrain from fostering that transaction but should find the parties liable for their violation. Moreover, the transactions to be encouraged should be voluntary and reflect the parties' true intentions. Transactions that are based on fraud, duress or other faulty expressions of intentions typically do not accord with one or both parties' will and interest. As a result, they are often unfair and unjust. With respect to such transactions, we should protect the disadvantaged party with rules such as those on contract modification and voidability, discussed below, and enforce such contracts only after their defects have been cured by the parties.

To regulate contracts based on the principle of fostering transactions is especially important in China. Because of the underdevelopment of the market economy in China, legislators have long ignored the importance of using contract rules to encourage transactions. For instance, Article 58 of the GPCL provides an over-broad list of invalid civil acts. In particular, it regards as invalid all civil acts that are conducted through fraud, duress, exploiting a party's emergent situation and other

means that violate a party's true intention.[65] To be sure, such provisions may be, to some extent, helpful in maintaining social order. However, by treating such contracts not as voidable, but as void or invalid per se, these provisions have improperly expanded the scope of invalid contracts. This is because whether an expression of one's intent is truthful is typically known only to the party itself; outsiders -- including the court or arbitration tribunal -- often have difficulty in making a judgement thereof. After all, if the victim of fraud or duress does not voluntarily divulge the fraud or duress (such as by filing a lawsuit with the court), the outsiders will typically have no way of knowing its existence.

Granted that such contracts are defective, there are situations where the victim may want the contract to remain binding on herself as well as the other party, rather than voiding the contract entirely. Even under such circumstances, however, the GPCL will, per Article 58, require the contract to be declared invalid and the victim's wish to go unfulfilled. Under the previous contract laws, because the state was given substantial authority to voluntarily declare such contracts as invalid, there occurred many instances where transactions were unnecessarily eliminated and the victims and well-intentioned third parties failed to be sufficiently protected.

As the previous contract laws were problematic in voiding too many contracts, they also lacked necessary limitations on contract termination where there was a breach. For instance, Article 26 of the Revised Economic Contract Law provided that where "one party [did] not perform ...within the time limit specified in the contract," the non-breaching party had the right to notify the other party and terminate the contract. According to this provision, as long as the obligor failed to perform within the specified time period, no matter whether the breach had produced any significant consequence, the obligee had the right to terminate the contract. In fact, it thus allowed one party to freely exercise its termination right even when the other party was merely delaying its performance.

This provision was apparently improper. In practice, many courts had decided, based on Article 26, that once a party breached, no matter how trivial the breach might have been, the contract could be declared to be terminated; and where a contract was declared invalid or terminated, the transaction dissolved, even though the parties may have wished to have it continue. Upon a contract's invalidation or termination, the parties were

65. GPCL, *supra* note 11, art. 58(3).

to return to each other, according to the principle of restitution, the property that had been delivered or to pay damages where the situation demanded. This not only means that the expenses of the parties' performance were uncompensated and the purpose of their contract frustrated, but also that additional costs had to be incurred for the return of property, thus resulting in even greater loss and waste. The loss and waste would be especially serious where a product had been custom-made for a party and no other user could be located for that product. To promote economic efficiency as well as freedom of contract, transactions must be fostered and the law must refrain from invalidating or terminating contracts in disregard of the parties' wishes.

To rectify such weaknesses and deficiencies in the previous contract laws, especially those concerning contract validity and termination, the Contract Law follows the principle of fostering transactions and effects many substantial revisions. Specifically, the Contract Law has embodied the principle of fostering transactions in the following major respects:

1. The concept of an invalid contract

In addition to listing four special types of invalid or void contracts,[66] the Contract Law explicitly provides that invalid contracts are those that "violate mandatory provisions of a law or administrative regulation."[67] This provision is crucially important in that it signifies that not any just regulatory document (*guifanxing wenjian*) will invalidate a contract; only where a national law (*falü*) or administrative regulation (*xingzheng fagui*) is violated may a contract be declared invalid. Furthermore, it is not that any violation of any provision of a law or regulation will entail contract invalidation. Only where a mandatory, not merely an elective, provision is violated may the contract be invalidated. In comparison with the previous contract laws, this has greatly limited the scope of invalid contracts.

66. These include contracts 1) that are entered through fraud or duress and harm the State interests; 2) whose parties collude maliciously to harm the interest of the State, the collective or a third party; 3) that conceal an unlawful purpose with a lawful form and 4) that harm the public interest. Contract Law, *supra* note 1, art. 52.

67. *Id.*

2. The distinction between void and voidable contracts

The Contract Law strictly distinguishes void contracts from voidable contracts. Voidable contracts are generally contracts that lack a genuine expression of the parties' intention.[68] In the case of a voidable contract, if the party holding the right of termination does not voluntarily request the contract to be terminated, then it shall be valid.[69] Where the party requests to modify the contract and is silent about termination, the court shall not terminate the contract and thus eliminate the contracted-for transaction.[70]

But even if the disadvantaged party wishes to terminate the contract, if by modifying terms of the contract the court can sufficiently protect the party's interest without violating the law or public interest, the court should generally refrain from terminating the contract. This will help foster transactions and avoid or reduce loss and waste that will result from terminating a contract and having the parties return each other's property.

Therefore, under the Contract Law, the disadvantaged party to a contract that is formed through fraud, duress or the exploitation of the party's emergent situation shall have the right to ratify the contract as long as such contracts do not harm the State interest. Being voidable and not void per se, the contract can be validated in accordance with the victim's free will. This treatment is clearly in line with the principle of fostering transactions.

3. The distinction between void contracts and contracts of pending validity

The Contract Law also distinguishes contracts that are void from contracts whose validity is pending (*xiaoli daiding*). A contract with pending validity means that although the contract has been formed, because it does not fully comply with the relevant provisions on validity, whether it is valid will hinge on the right-holder's manifest ratification.[71] Such contracts mainly include those 1) that are concluded by persons with no capacity or with limited capacity for civil acts; 2) that are concluded in the

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68. *See* Contract Law, *supra* note 1, art. 54.
69. *See* Contract Law, *supra* note 1, art. 55.
70. *See* Contract Law, *supra* note 1, art. 54.
71. Cf. ZHOU LINBIN ET AL., BIJIAO HETONG FA [COMPARATIVE CONTRACT LAW], 410 (Lanzhou Daxue Chubanshe [Lanzhou University Press] 1989).

name of a principal by a person who has no authority as agent or who in concluding the contract exceeds her authority as agent; and 3) that are formed by persons with no authority to dispose of the property specified in the contract.[72]

Such contracts were all treated as invalid per se by the previous contract laws. This is apparently improper. On the one hand, the defects of these contracts can be easily cured by the right-holder if she determines that the contract is in her interest. For instance, where a person with no agency authority concludes a contract for an intended principal, the contract may very well be what the principal would have wanted. It is entirely proper, therefore, to validate the contract upon the principal's voluntary ratification. This is because the ratification indicates that the contract is in accord with the right-holder's will and interest and thus constitutes a valuable transaction for both parties. If we treat these contracts as invalid, we will be depriving the right-holder of his right to ratify the contract.

Moreover, to validate a contract with the right-holder's ratification does not violate the law and public interest. On the contrary, it promotes more transactions that are in the contracting parties' interest and better protects the parties' interest and free will.

For the reasons stated above, the Contract Law distinguishes invalid contracts from contracts of pending validity, treating the latter as a particular type of contract and providing reasonable special provisions thereon.[73]

4. The distinction between contract formation and contract validity

In comparison with the previous laws, the Contract Law draws a much clearer distinction between contract formation and contract validity. For a long time, because China's previous contract laws made no such distinction, many courts treated contracts that were formed but lacked certain conditions for taking effect as invalid contracts, thus invalidating a great number of contracts that should have been deemed valid.

In fact, contract formation and validity are categorically different. Contract formation refers to the completion of the process whereby the

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72. *See* Contract Law, *supra* note 1, articles 47-51.
73. *See id.*

parties through equal consultation come to agree on the terms of their contemplated transaction. However, a contract does not automatically become valid as it is formed. Contract validity largely depends on the state's attitude to and evaluation of the contract in question. In other words, contract formation is mainly governed by the parties' free will and the principle of freedom of contract. In contrast, contract validity chiefly reflects the state's evaluation of and intervention in contractual relationships.

The Contract Law follows the principle of fostering transactions in designing its rules on contract validity. For instance, the law allows various ways to validate a contract despite its deficiencies. If a contract lacks major terms or if these terms are ambiguous, the court should reasonably interpret the contract to allow the parties, if they so wish, to be bound by it, rather than simplistically declare the contract as invalid and thus eliminate the transaction. The Contract Law provides for contract formation and validity in Chapters 2 and 3, respectively. In section 5, below, we discuss contract formation in greater detail, whereas section 7 will again touch on the subject of contract validity and interpretation.

5. Rules on contract formation

China's previous contract laws lacked provisions on contract formation, or offer and acceptance. This not only made it difficult for parties to form a contract but also created a situation where there was no standard for determining if a contract had been formed when this became an issue of dispute between the parties. The lack of provisions on contract formation was closely connected to the invalidation of many contracts that were already formed. Because the previous contract laws and regulations did not provide any clear rules on contract formation but instead enumerated major terms for various contracts,[74] and because the legislators had not offered any clarification as to the nature of these terms, there had been a widespread misunderstanding, viz., that the contracts specified must contain these enumerated terms. As a result, many courts had held that contracts lacking any of these major terms were invalid, thus creating a great number of invalid contracts.

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74. For example, the Gongkuang Chanpin Gouxiao Hetong Tiaoli [Rules on Purchase and Marketing Contracts Concerning Industrial and Mineral Products] provided for 12 necessary terms for contracts involving industrial and mineral products; the Economic Contract Law listed 5 major terms for economic contracts in general. *See* Economic Contract Law, *supra* note 6, art. 12.

In response, the Contract Law establishes a complete set of rules on contract formation, which substantially reflects the principle of encouraging transactions. Article 12 of the Contract Law explicitly provides that the contents of a contract are to be decided by the parties through mutual agreement,[75] thus allowing parties freely to determine the terms of their contract. In addition to upholding freedom of contract, this provision is exceedingly favorable to parties' structuring their own transactions.

Similarly, the Contract Law's rules on offer and acceptance[76] are designed to facilitate formation of contracts and transactions. For instance, according to the traditional continental theory, offer and acceptance must be identical in their contents. A reply that adds to, limits or modifies the original offer is equal to a refusal of the offer. This traditional view, however, has come to be regarded as unfavorable to the formation of contracts and the fostering of transactions. The United Nations Convention on the International Sale of Goods, for example, now adopts the rule that where the acceptance modifies immaterial contents of the offer and the offeror does not promptly manifest her objections thereto, the contract shall be deemed as formed.[77] The same rule has been adopted by Article 31 of the Contract Law.

6. Form of a contract

There have always been two differing views in China as to the proper form of a contract. One view held that the provision in the previous contract laws, that contracts should be in written form,[78] was mandatory. If the parties did not put their contract in writing, then the contract was not yet formed, and thus could not be valid. The other view pointed out that the rationale for this written requirement was that the written form would best prove the existence and terms of the contract. If the parties failed to put their contract in writing, then there was difficulty in proving the contract and its terms.[79]

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75. *See* Contract Law, *supra* note 1, art. 12.

76. *Id.* articles 13-31.

77. CISG, *supra* note 28, art. 19.

78. *See* Economic Contract Law, *supra* note 6, art. 3; Foreign Economic Contract Law, *supra* note 7, art. 7; Technology Contract Law, *supra* note 8, art. 9.

79. Su Huixiang ed., ZHONGGUO DANGDAI HETONGFA LUN [ESSAYS ON CONTEMPORARY CHINESE CONTRACT LAW], 87 (Jilin Daxue Chubanshe [Jilin University Press] 1992).

The courts had generally adopted the first view. But although this interpretation would compel the parties to use the written form and thus reduce contractual disputes, it constituted an overly rigid requirement that may have prevented many transactions from taking place. On the one hand, there are situations where, although the parties have for various reasons failed to adopt the written form, they have already partially or fully performed or, although the contract has not yet been performed, the parties have no disputes as to the contract's existence and major terms. Under these circumstances, denying the contract's formation will be eliminating a transaction that is desired by both parties. For speediness and convenience, many parties in today's marketplace have taken to telephone, audio-recording, video-recording and other means in forming their contract. To refuse to recognize all such contracts as properly formed will undoubtedly frustrate or at least inconvenience many significant market activities.

In the spirit of fostering transactions, the Contract Law has now adopted the view that the form of a contract is evidence for the contract's existence, rather than a criterion in deciding whether the contract has been formed. Article 10 of the Contract Law provides that "[f]or parties to form their contract, there are written, oral, and other forms." It is clear that, except for contracts that according to a law or administrative regulation must be in writing[80] or that need to be registered and approved,[81] parties in forming their contract may now adopt the oral form. Where the parties have not put their contract in writing, the parties should be allowed to adduce evidence to prove the existence of their contract and its major terms. If the parties fail to produce adequate evidence, then the contract is to be declared non-existent. But when adequate evidence is presented, the contract shall be deemed as properly formed and valid.

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80. Contract Law, *supra* note 1, art. 10.

81. These include, for example, Sino-foreign joint venture contracts(*zhongwai hezuo jingying hetong*) and equity joint venture contracts (*zhongwai hezi jingying hetong*). Out of necessity, these contracts have to be in writing when submitted to the relevant registering and approving authorities. *See* Article 7(3), Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa [The People's Republic of China Law on Sino-foreign Cooperative Enterprises] (adopted April 13, 1988, effective April 13, 1988) and Article 3, Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Fa [The People's Republic of China Law on Sino-foreign Joint Equity Enterprises] (adopted July 1, 1979, effective July 1, 1979). An English translation of these laws can be found in CCH, *China Laws for Foreign Business - Business Regulation*, Vol. 1, ¶6-100(5) and ¶6-500(3), respectively.

7. A system for contract interpretation

Because the previous contract laws did not provide for a system of contract interpretation, in practice the courts often treated contracts whose contents were unclear or ambiguous as invalid, thus causing many transactions to be eliminated. This apparently contravened the spirit of fostering transactions; and a system of contract interpretation must be established to allow judicial protection of the contracting parties as well as their transactions.

Some scholars were concerned that allowing courts to interpret contracts would increase the judge's discretion and thus interfere with the parties' free will and interest. Although this opinion was not entirely unreasonable, where there was no system of contract interpretation and the judges were to treat as invalid any contracts that were slightly deficient or unclear, the judges were in fact exercising a greater degree of discretion. Only by providing a system of and clear standards for contract interpretation, can the judge's discretion be appropriately restrained.

The Contract Law now provides for such a system of contract interpretation. Article 41, for example, directs the judges to interpret terms of a form contract by their "prevalent meanings."[82] Where there are two or more equally prevalent meanings, the courts should adopt the one that disfavors the party who provided the form contract.[83] Similarly, Articles 62, 63, and so on, provide concrete guidance on standards to follow where the contract in question is ambiguous as to the quality, price or compensation, location of performance, the time limit for performance, and other components of the contract. These standards for contract interpretation are generally in line with the principle of fostering transactions, as well as those of good faith and freedom of contract.

8. Conditions for terminating a contract where there is a breach

The Contract Law strictly limits the conditions for terminating a contract where there is a breach. In contract law, where one party breaches a contract, the other often has the right to terminate the contract upon the fulfillment of certain legal conditions. Contract breaches therefore form a

82. Contract Law, *supra* note 1, art. 41.
83. *Id.*

major cause for contract termination. However, this does not mean that any breach will entail the termination of a contract. Contract termination is, in its nature, the extinction of a transaction. In many situations, if the non-breaching party is willing to accept the breaching party's performance even after the breach, or if continuation of the contract is possible and will not harm the non-breaching party, terminating the contract not only does not add to the protection of the non-breaching party, but also does not reflect the contract law's purpose of fostering transactions. Thus the law must provide clear limitations on contract termination where there is a breach.

In view of the many weaknesses in China's previous contract laws in this regard, many Chinese scholars suggested that the new Contract Law should place greater emphasis on the law's function of fostering transactions and allow termination of contract only where the breach has serious consequences.[84] The Contract Law has adopted this opinion, providing that, absent any unreasonable delay of a major obligation (*zhuyao zhaiwu*), only where a party's delay or breach renders the purpose of the contract incapable of being fulfilled can the non-breaching party have a right to terminate the contract.[85] The rationale for this is, where the breach has produced such serious consequences (including damages), the purpose of the non-breaching party in entering the contract may not be materialized and thus the contract may no longer have any substantial significance. Under these circumstances, therefore, the law should allow the non-breaching party to terminate the contract, thus freeing the party from a contract that has been seriously violated. Such limitations on the termination of contact where there is a breach will encourage transactions, as well as avoid property loss and damages that may result from improper termination of contracts.

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84. *See, e.g.*, Cao Shiquan and Zhu Guangxin, *HETONG FADING JIECHU DE SHIYOU TANTAO [AN EXPLORATION OF LEGAL CAUSES FOR CONTRACT TERMINATION]*, ZHONGGUO FAXUE [CHINESE JURISPRUDENCE], No. 4, 1998, at 34-47.

85. *See* Contract Law, *supra* note 1, art. 94(3) and (4).

VI. CONCLUSION

The Contract Law represents a significant improvement over China's previous contract laws. In view of the contradictions and redundancies among the previous contract laws, their lack of basic contract rules (such as those on offer and acceptance), as well as their problematic notion of "economic contract," the Contract Law provides a more advanced, comprehensive, and systematic contract law regime that is better suited to China's transitional economy. The three fundamental principles of the Contract Law, namely, freedom of contract, good faith, and the fostering of transactions, constitute the main spirit of the Contract Law and bring it more in line with international business practice.

As with any complex piece of legislation, of course, there may arise various problems and issues as the Contract Law is being implemented and interacts with various courts, arbitration tribunals, practicing lawyers, as well as particular contracting individuals and entities in their multitude of legal and/or business contexts. To tackle such problems and issues as they emerge, especially when China's business practice is in a flux and rapidly evolving, will undoubtedly be a serious and fascinating challenge.