

UCLA

UCLA Pacific Basin Law Journal

Title

A Survey of China's Economic Contract Law

Permalink

<https://escholarship.org/uc/item/95s5m56g>

Journal

UCLA Pacific Basin Law Journal, 4(1-2)

Author

Wang, Guiguo

Publication Date

1985

DOI

10.5070/P841-2021920

Copyright Information

Copyright 1985 by the author(s). All rights reserved unless otherwise indicated. Contact the author(s) for any necessary permissions. Learn more at <https://escholarship.org/terms>

Peer reviewed

A SURVEY OF CHINA'S ECONOMIC CONTRACT LAW

Guiguo Wang*

I. HISTORICAL BACKGROUND

Since the adoption of the Economic Contract Law of the People's Republic of China (hereinafter referred to as the "Contract Law") on December 13, 1981,¹ there has been enthusiasm and curiosity regarding its implementation and its impact on China's legal and economic systems. Owing to the fact that the Contract Law has been in force for less than four years, very few cases have been decided under it, and very little commentary has been available about it outside China. This article will summarize the Chinese practice in enforcement of contracts, analyze the basic features of the Contract Law, compare its provisions with Chinese customs, and outline its impact on Chinese society.

Even during the imperial period, when no officially promulgated contract law existed, the Chinese government recognized contracts entered into by its people. The case of Chen Minsheng and Lu Siyi,² decided by District Magistrate Yu Chenglong early in the Qing Dynasty (1644-1911 A.D.) illustrates this point. The facts of the case are as follows: Lu's grandfather took a loan from Chen's grandfather in the Ming Dynasty (1368-1644 A.D.). Several years after the loan was made, the Manchus overthrew the Ming and es-

* J.S.D., Yale University; LL.M., Columbia University. This article was written while the author was visiting at Paul, Hastings, Janofsky & Walker, Los Angeles, California. The author has served in the Department of Law and Treaties of the Foreign Ministry of the People's Republic of China (1979-80).

The author would like to thank Professors William Alford and Whitmore Grey for their kind assistance and valuable comments in the preparation of this article.

1. The Contract Law was adopted at the Fourth Session of the Fifth National People's Congress of China on December 13, 1981 and entered into effect on July 1, 1982. The citations in this paper are unofficial translations. There is no official English translation of the text available. The official Chinese text is contained in GUO WU YUAN JING JI FA GUI YAN JIU ZHONG XIN BAN GONG SHI (Office of Economic Law Study Center, State Council), JING JI FA GUI XUAN BIAN (Selected Economic Law Statutes) (1980) [hereinafter cited as CONTRACT LAW]. The Chinese short form for referring to the Contract Law is *He Tong Fa*.

2. GU DAI PAN LI XUAN (Selected Ancient Decisions) 34 (C. Gao ed. 1981).

established the Qing Dynasty. The Lu family had made contributions to the Qing government and become prosperous, while the Chen family was in decline. When Chen Minsheng asked Lu Siyi to pay back the money borrowed by Lu's grandfather, Lu refused to pay, arguing that the money was borrowed before the Qing Dynasty was established and that the change in government voided the loan contract. Magistrate Yu decided the case in Chen's favor. His reasoning was that since the loan contract was signed and verified as true, Lu could not deny the indebtedness. He was party to a valid contract and was required therefore to repay the loan in spite of the fact that the contract had been entered into during a different dynasty.³

Since the establishment of the People's Republic of China on October 1, 1949, the Chinese legal system has suffered ups and downs. In the 1950's and early 1960's, the Chinese government attached importance to the making and enforcement of contracts. In September 1950, the Financial and Economic Committee of the State Council⁴ issued a set of "Provisional Regulations regarding Contracts by Government Organs, State-Owned Enterprises and Collectives."⁵ These regulations provided that damages caused by non-performance under a contract must be remedied by the non-performing party.⁶ In October 1950, the then Trade Ministry of the Central Government adopted a "Resolution on Serious Formation of and Strict Performance of Contracts."⁷ This resolution also emphasized the legal effect of contracts and stated that the parties to a contract must carry it out in good faith. The "Circular on Strictly Following the Construction Procedures and Strictly Carrying Out the Terms of Economic Contracts," adopted by the Central Committee of the Chinese Communist Party and the State Council in December, 1962, required every economic entity to fulfill its obligations under economic contracts.⁸ It provided that the purchaser might refuse to accept goods not conforming to the specifications of the contract, in which case the supplier had to bear any losses resulting from such refusal. If the goods conformed to the contractual requirements, however, the purchaser had an obligation to pay,

3. *Id.* at 35-37.

4. State Council is the administrative branch of the Chinese government. It is in charge of both internal and external executive affairs of the country.

5. See Z. Wei, *The Legal Effect of Economic Contracts*, in JING JI FA WEN XUAN (Selected Economic Law Articles) 68 (H. Guan ed. 1981).

6. *Id.*

7. *Id.*

8. *Id.* In the 1960's, the functions and responsibilities of the Chinese Communist Party were not quite distinguished from those of State Council. Sometimes, the Party and State Council issued joint administrative decrees. But strictly speaking, decrees by the Communist Party do not have legal and binding force, although decrees and administrative orders by State Council may be in conformity with the policy adopted by the Party.

and if any damages arose from his non-payment, he had to bear the losses.⁹

Use of contracts as a tool for implementation of economic plans, however, was short-lived. From the mid-1960's to the late 1970's, economic contracts were replaced by administrative orders. Not until December 13, 1981, when the Contract Law was adopted and promulgated, was the system of economic contracts fully reinstated in China.

II. PRACTICES PRIOR TO 1982

Many cases dealing with contract issues were decided by arbitration tribunals and courts between the late 1970's and the adoption of the Contract Law late in 1981. The following case, decided in May of 1980, is illustrative of this case law, much of which influenced the ultimate shape of the Contract Law itself. Of particular interest in this case is its treatment of the issues of formation, of the excusal of performance because of government action, and of the extent of a breaching buyer's liability.

On April 10, 1979, the Distribution Department of the Ministry of Construction Materials assigned¹⁰ a 2850 × 39 meter steam-pressure boiler (the Boiler) to the Ministry of Railways upon the latter's request. The Boiler was eventually assigned to a component factory in Beijing (the Buyer).

In April of 1979, a representative of the Buyer went to the repair and assembly factory in Shenyang City (the Seller) with the assignment certificate to examine the Boiler. The representative told the Seller that the Boiler was suitable for the Buyer and that he would need his company's approval to sign a purchase contract. Upon the representative's departure for Beijing, the Seller asked him to take a standard form contract used by the Seller with him and advised him that if the Buyer needed the Boiler it should put its seal on the contract, which would constitute the making of a valid contract according to Chinese practice before the Contract Law entered into effect.

The Seller did not hear from the Buyer until May 30, 1980, when it received a cable reading, "Agreed, ship the 39 meter boiler to Changping Railway Station. Paperwork being taken care of." Apparently in response to a state plan revision which ultimately eliminated its need for the Boiler, on June 15 the Buyer sent another cable which read "Still securing funds, stop shipping the ordered boiler temporarily." Disregarding the second cable, the Seller shipped the Boiler to Changping Railway Station, but the Buyer

9. *Id.*

10. Assigned: *Fen Pei*.

refused to pay for the Boiler because no contract had been signed. It argued that the goods did not suit its project. The Seller brought a lawsuit in a court in Beijing demanding enforcement of the contract.¹¹

The plaintiff Seller basically made three arguments: (1) that the first cable constituted a signing that completed the formation of a valid contract; (2) that the Boiler was a specially manufactured item, which according to the provisions of a relevant administrative decree could not be refused by the purchaser; (3) that the term "stop shipping temporarily" in the second cable did not cancel the sale agreement. Plaintiff therefore demanded payment of the price of the Boiler, shipping cost and a delayed payment charge in the sum of 218,726 yuan (approximately \$145,817).¹²

The defendant argued that the contract was the basis of the legal obligation, and that if the alleged contract was not sealed by either party, it could not be regarded as valid. It further argued that the cable should not be considered part of a valid contract or sufficient to make an invalid contract valid. Based on the above arguments, it stated that since there was no valid contract between the two parties, there was no reason for it to have sought cancellation of the "contract."¹³

In addition to the formation issue, this case also involved the relationship between contract and state plans as well as Chinese practice concerning the supply of goods. In its decision the court stated that the contract form provided by the Seller constituted an offer and that the first cable sent by the Buyer represented its consent to the contract. In the opinion of the court, a contract was entered into upon receipt of the cable by the Seller.¹⁴

The court emphasized the general practice in supply contracts over formality. It stated that if both parties conferred and examined the goods and seller agreed to sell even without a signed agreement, a telegram requesting shipment of goods itself constituted a valid acceptance which should bind both parties.¹⁵ Although the court did not clarify in what situations a telegram might be regarded as evidence of a valid contract, presumably the basic test is that it be the manifestation of the mutual consent of the parties concerned. In other words, only when there has been an

11. JING JI HE TONG JU FEN AN LI XUAN BIAN (Selected Cases of Economic Contract Disputes) 25 (1982).

12. *Id.* at 26.

13. *Id.*

14. *Id.* at 27. This decision reflects Article 3 of the Contract Law, which provides that documents, telegrams and charts relating to a contract are regarded as component parts of the contract.

15. *Id.* at 26.

offer would a telegram or letter constitute an acceptance creating a valid contract.

Regarding the issue of whether the Boiler was specially made for the Buyer, the court decided that prior to 1980, boilers of that kind were made under a mandatory state plan, and that therefore the purchasing party did not have the right to refuse a contract after examination of the product. Nevertheless, considering that the Buyer was no longer in need of the Boiler when the state plan had been revised, it might be allowed to return the product on the condition that a penalty be imposed. The court's conclusion was based on the fact that the Boiler was not specially made for the Buyer. It could be used by other companies and for other purposes.¹⁶ Although the court did not specify that it was applying such a "useability" test, this was apparently an important factor in the decision.

In the end, the court decided that the Buyer should pay a penalty fee of 42,000 yuan, 20% of the price of the Boiler. Since the Seller did not stop shipment of the Boiler upon receipt of the second cable, it was charged with the shipping cost. At the same time, the Buyer was to take care of the Boiler until the Seller was able to resell the product.¹⁷

Chinese practice generally favors specific performance. Thus, one may wonder why the court did not order the breaching purchaser to make payment in full. The reason for the court's leniency seems to have been that, in the court's view, the modification of the applicable state plan moderated the purchaser's responsibility for the breach. Had the state plan not been revised, the purchaser would have secured financing and made the payment. Furthermore, since the Boiler could be used by other companies, the only loss the seller might suffer would be the loss due to a delayed sale. The penalty was apparently designed to compensate for that economic loss.

Economic losses or losses of profit have been explicitly recognized as compensable in China. For instance, in an arbitration award by a tribunal in Chongqing City, a manufacturing company was required to pay 25,000 yuan to compensate for economic losses caused when it breached a contract.¹⁸ The manufacturing company had entered into a contract with a department store to supply a certain number of electric fans to the latter. The market improved greatly, and a decision was made to retail the fans directly rather than sell them to the department store. The arbitral tribunal decided that the breach of contract by the manufacturing company

16. *Id.* at 27.

17. *Id.*

18. *Id.* at 36.

had deprived the department store of expected profits and that since the manufacturing company would not be able to specifically perform, compensation for the loss was required.¹⁹

The extent of economic compensation varies from case to case. Some of the tribunals and courts allow what is in effect punitive compensation for economic loss as high as 20% of the agreed price.²⁰ In other cases, economic loss has been assessed to be 5% of the agreed price, including litigation fees, transportation, lodging and other incurred expenses.

At this point, consider a 1980 case decided by the highest court of Henan Province, involving a collectively owned store and a state-owned department store.²¹ The facts of the case are as follows. In January of 1980, a department store and a collective signed a contract under which the department store would supply 100 sewing machines to the collective. Delivery was not made in April of 1980 as provided in the contract. When the department store had the sewing machines available in June 1980, it requested the collective to pay before delivery, which was not required by the purchase contract signed in January. The latter agreed. The collective, however, could not transfer the money to the department store in time. The department store then sold all the sewing machines immediately, for the demand for that kind of sewing machine was very high. It made a 791.82 yuan profit. The collective sued for loss of profit caused by the non-performance of the department store.

When a decision by the intermediate court was appealed by the defendant to the highest court in Henan, the court decided that the department store must pay 825 yuan, 5% of the contract price, to the collective.²²

The basis on which the final decision was reached seems to have been that the department store's non-delivery and self-marketing constituted a breach of contract and that the collective should receive the profit it could have made had the department store not breached the contract. Yet the administrative costs incurred by the collective in reliance on the contract were considered a normal business expense, and so not compensable. Since there was no specific substantive law available at that time, the case was decided more or less in accordance with the principle of *ex aequo et bono*.²³

19. *Id.* at 37.

20. In arbitration conducted in 1980 in Qingdao, the plaintiff was awarded 20% of the agreed price for tomatoes as a penalty for economic loss. *Id.* at 35-36.

21. *Id.* at 53.

22. *Id.* at 55.

23. *Ex aequo et bono* means "according to equity and conscience." BLACK'S LAW DICTIONARY 472 (5th ed. 1979).

III. BASIC FEATURES OF THE CONTRACT LAW

China's Contract Law has seven chapters, with a total of fifty-seven articles. Chapter One sets forth the purpose and scope and the general principles of the Law. Chapter Two subdivides contracts into ten categories,²⁴ and sets specific requirements for the making and enforcement of contracts falling within each category. Chapters Three through Seven contain provisions in connection with the amendment and cancellation of contracts, liabilities for breach, the resolution of disputes, the management of contracts and supplementary provisions. In line with the detailed listing of the required contents for each of the ten types of contracts, the Contract Law also specifies the legal duties of the parties to each type of contract.²⁵

The Contract Law defines an economic contract as "an agreement between legal persons which defines their mutual rights and obligations for the purpose of realizing certain definite economic goals."²⁶ The term "economic contract" is not drawn from Western jurisprudence, but it need not cause any more confusion than do terms of art used in the West. As indicated, contracts covered by this law must have an economic orientation. This may include supply contracts and other contracts involving economic activities. Although the Economic Contract Law does not further define what constitutes "economic purposes," any activity which involves monetary or commercial matters may be regarded as having an economic purpose, and the Contract Law should cover at least all contracts which involve commerce.

There is some confusion in the West over the existence of "legal persons"²⁷ under Chinese law. This confusion seems to arise from dual assumptions: first, that there is nearly universal state ownership in China; second, that given extensive state ownership, the existence of independent entities is impossible. While a full discussion of the distinction between a legal person and its "owner" is beyond the scope of this article, briefly it might be said that in China, as elsewhere, a legal person is a legal fiction. In order for China to carry out its modernization program and do business with foreign enterprises, there must be a means of making the Chinese party to an agreement accountable, while limiting its liability in case

24. These categories are: purchase and sale contracts; processing contracts; shipping contracts; electricity supply and consumption contracts; warehouse storage contracts; property leasing contracts; loan contracts; property insurance contracts; and scientific and technological cooperation contracts.

25. CONTRACT LAW, *supra* note 2, arts. 38-47.

26. *Id.* art. 2. For the purpose of realizing certain definite economic goals: *Wei Shi Xian Yi Ding Jing Ji Mu Biao*.

27. Legal person: *Fa Ren*.

of a dispute. This is accomplished by separating the government from business entities.

This distinction, between the government and legal persons, need be no more troublesome than the Western distinctions between a parent company and its subsidiary, between the government and a government-owned corporation, or between a corporation controlled by a single family and the family itself. These distinctions can be made in theory, and in legal sense. A parent company and its subsidiary are separate legal persons despite the fact that they may even have common management.

Under Chinese law, a legal person is an entity which has secured its lawful personality through legal procedures and is therefore recognized by the state.²⁸ At the same time, a legal person should have its own independent budget and assets. Another characteristic of a legal person is its ability to enjoy contractual rights and to undertake legal obligations. There are currently at least six kinds of legal persons in China.²⁹

In addition to its application to contracts between legal persons, the Contract Law is also applicable to contracts between legal persons and natural persons in rural areas (i.e. individual farmers).³⁰

Generally speaking, an economic contract must be in writing unless it can be immediately performed.³¹ Thus, at least implicitly, the Contract Law recognizes both oral and written contracts. This is also in conformity with Chinese practice, especially in rural areas. Most of the farmers are not accustomed to written contracts and conduct business mostly by oral agreements. Although Article Three of the Contract Law does not explicitly authorize the use of oral contracts, from the language, "[w]ith the exception of those

28. GUO WU YUAN JING JI FA GUI YAN JIU ZHONG XIN BAN GONG SHI (Office of Economic Law Study Center, State Council), ZHONG HUA REN MIN GONG HE GUO JING JI HE TONG FA TIAO WEN SHI YI (Interpretations of the Economic Contract Law of the People's Republic of China) 12 (1982) [hereinafter cited as INTERPRETATIONS]. Although the People's Congress is vested with the right regarding interpretation of Chinese laws, the interpretations offered by the above Office may carry authoritative force.

29. Namely, state organs and institutions with separate budgets, state-owned economic enterprises responsible for their own losses and profits, collectives which own assets and are responsible for their own losses and profits, joint ventures by the above-mentioned economic entities, associations with independent accounting, such as non-profit or social organizations, and lawfully organized Chinese-foreign joint ventures, wholly foreign-owned enterprises and other organizations qualified as legal persons under Chinese law.

It is said that Offices of state organs, workshops of a company, affiliated factories, departments or schools of universities, specialization groups of production teams, etc. are not legal persons. *Id.* at 13-14.

30. CONTRACT LAW, *supra* note 2, art. 54. Private enterprises have been sweepingly established in China. The total number has grown to several million.

31. *Id.* art. 3.

that can be performed immediately...[contracts] shall be in written form," it is clear that oral contracts shall have the same effect as written contracts, if they can be immediately performed.

Three requirements must be satisfied in order for a contract to be valid. First, both parties (or agents of the parties) must be present.³² Secondly, both parties must have achieved unanimity regarding principal provisions of the contract through consultation.³³ Thirdly, the contract must not otherwise conflict with Chinese law.³⁴

Unanimity through consultation refers to the steps leading to contract formation. As in common law jurisprudence, the Chinese law makes the "offer" and "acceptance" two essential elements of a contract. In addition to the general desire to enter into a contract, an offer must contain the principal provisions of the contract to be entered into and the time period during which the offer should be kept open. An offer is regarded as a juristic act³⁵ under Chinese law; the person who makes the offer is legally bound and must bear the consequences therefrom. Within the time period described in the offer, the offeror "must be bound by the offer; that is (1) the offeror has the obligation to enter into a contract with the party accepting the offer and (2) the offeror may not make the same offer or enter into the same contract with a third party."³⁶ If the time period in which an offer remains in force is not specified in the offer, presumably a reasonable period would be allowed.

There are two requirements for a valid acceptance. The offeree "must accept unconditionally all the terms of the offer" and "must make the acceptance within the time period stipulated in the offer."³⁷ In case the offeree modifies or supplements the offer or the offeror receives the acceptance after the offer expires, the offeree's acceptance is regarded as a counter-offer. No contract will be made until the parties reach unanimity or agreement.

The concept of consideration in the common law is also recognized in Chinese contract law. Article Two of the Contract Law provides for "mutual rights and obligations." The term mutual right may be interpreted as referring to mutual benefits under the contract. In the interpretation offered by the Office of Economic Law Study Center, consideration in a sales contract was described as, for example, consisting of the purchaser's acquisition of the

32. In Chinese practice, a contractual party sometimes appoints a third person as its agent to negotiate and execute contracts on its behalf.

33. Principal provisions: *Zhu Yao Tiao Kuan*.

34. CONTRACT LAW, *supra* note 2, art. 9. In practice, contracts may be entered into by mail, etc.

35. Juristic act: *Fa Lu Xing Wei*.

36. INTERPRETATIONS, *supra* note 28, at 28.

37. *Id.*

ownership of the goods that are the subject of a contract in exchange for the Seller's receipt of money for these goods.³⁸

Article Five of the Contract Law provides: "Economic contracts must be made by implementing the principles of . . . compensation of equal values." Based on this article, one may conclude that parity of consideration at the time of formation is required. In case of a dispute, disparity of consideration may be an argument for avoiding a contract.

Economic contracts that violate the law, state policies or state economic plans are void *ab initio*.³⁹ This provision is aimed at preventing and punishing agreements to engage in illegal activities, such as speculation and profiteering, and noncompliance with foreign exchange regulations.⁴⁰ It also relates in part to state plans. There are currently two types of plans, mandatory⁴¹ and directive.⁴² Mandatory plans usually involve the most important projects and products in the national economic development program, such as construction of power plants and the manufacture of steel products. Since the activities covered by a mandatory plan have substantial impact on the national economy, parties to contracts concerning them must fulfill their obligations.

Directive plans are more general in nature. They are important to the national economy, but there are no fixed deadlines for meeting production targets or completing construction projects under these plans. As a result, parties to contracts related to such plans have more latitude. The parties can base their contract on their own economic situation and include provisions in the contract which differ from those of the directive plans.⁴³

Because of the role these state plans play in contracting in China, a question has been raised as to whether Chinese entities have full freedom of contracting. In response, it should be noted that every legal system places some restraints on contracting. In the United States some export contracts require government approval, while some other contracts are invalid because they are against public policy. Nevertheless, with these exceptions individuals and legal persons have the freedom to contract. The Chinese concept of the freedom of contracting should be understood and interpreted similarly.

Contracts can be amended or cancelled by agreement of the parties, provided such amendment or cancellation does not harm

38. *Id.* at 12.

39. CONTRACT LAW, *supra* note 2, art. 7(1).

40. For a detailed discussion, see INTERPRETATIONS, *supra* note 28, at 21-22.

41. Mandatory state plans: *Zhi Ling Xing Guo Jia Ji Hua*.

42. Directive state plans: *Zhi Dao Xing Guo Jia Ji Hua*.

43. See CONTRACT LAW, *supra* note 2, art. 11; see also INTERPRETATIONS, *supra* note 28, at 30.

state interests or impair implementation of state plans.⁴⁴ A contract may also be amended or cancelled by the revision or cancellation of the state plan on which it is based.⁴⁵ A contract may also become unenforceable because of *force majeure* or other factors not caused by either of the parties.⁴⁶

Force majeure is defined as an "event which is caused by forces outside the control of the parties and could not be avoided by exercise of due care, such as natural disasters, earthquake, war, etc."⁴⁷ Under Chinese law, the concept of force majeure is not absolute. Whether a certain event is under the control of the parties or could be avoided depends on the stage of scientific and technological development. Some disasters which were considered unavoidable in the past may be avoided at the present time. An event of force majeure also depends on the economic and scientific development of the area where it takes place. An event that constitutes force majeure in a backward area may not be the same in a highly developed place.⁴⁸ For instance, natural disasters such as earthquake, hailstones, typhoon and tidal wave are predictable in scientifically advanced areas. Upon warning by forecast, contractual parties are expected to take certain precautions to prevent damage to the subject of the contract. Failure to do so will result in liability for any loss resulting from the party's inaction. This rule may not be applied in areas where the disasters concerned cannot be forecasted due to the stage of scientific development.

In case one party fails to perform its contractual obligations within the period specified in a contract and an event of force majeure takes place subsequent to the delay or breach of contract, the breaching party must bear the losses caused by the force majeure.⁴⁹ The policy behind this provision is to encourage performance, by placing the risk of loss on the party that breaches the contract.

The Contract Law provides for contract remedies. The non-defaulting party always has the option of demanding specific performance.⁵⁰ With respect to money damages, it is required that every contract include a specific penalty provision for breach of the contract. If the amount specified in the penalty clause is not sufficient to compensate for losses resulting from a breach, the defaulting party must pay for the additional margin of damages as well.

If the breach is due to the fault of a higher authority (i.e. a

44. CONTRACT LAW, *supra* note 2, art. 27(1).

45. *Id.* art. 27(2).

46. *Id.* art. 27(4).

47. INTERPRETATIONS, *supra* note 28, at 72.

48. *Id.* at 73.

49. *Id.*

50. CONTRACT LAW, *supra* note 2, art. 35.

controlling corporation or governmental authority), that body is responsible. In such case, the defaulting party should pay the stipulated penalty. Then the breaching party must seek compensation in turn from the higher authority.⁵¹ This provision has no impact on the contractual obligations and liabilities of the parties to a contract. The defaulting party simply pays the non-defaulting party the compensation specified in the contract or assessed by the court, after which the higher authority takes the blame itself and compensates the defaulting party. Compensation may take the form of a deduction from the profit quota or tax that the defaulting party is required to submit or pay for that fiscal year, or it may take the form of a direct payment to the party.⁵²

It is clear from the provisions of the Contract Law that the provision for liquidated damages is intended as a penalty. The payment does not depend on the actual damages the non-defaulting party suffers. Even if no damage is suffered, the defaulting party must pay the amount stipulated in the contract. If actual damages exceed the stipulated amount, the amount paid under the penalty clause may be used to offset liability for any actual damages. The purpose of this provision is to encourage contracting parties to observe their legal obligations under a contract. The sanction provided under the Economic Contract Law is seen as a guarantee for the performance of contracts. In view of Chinese legal history and the legal knowledge of the public, the use of sanctions as a means to enforce contract may be appropriate.

Many contracts are entered into in accordance with state plans. Performance of contractual obligations is crucial to the fulfillment of mandatory state plans. Even contracts under directive plans are very important, for state and local governments to a large extent adopt these economic plans based on contracts entered into on the assumption that the contracts will be fulfilled. As a result, though a penalty for non-performance of a contract is available, the non-defaulting party may still request specific performance.⁵³ Upon such a request, the defaulting party is obligated to carry out the terms of the contract, unless specific performance is impossible.

In accordance with Chinese tradition and culture, the Contract Law encourages parties to a dispute arising from economic contracts to settle it amicably through consultation.⁵⁴ Mediation and arbitration are both recognized under the Contract Law. If a party to a dispute is not satisfied with the award by a mediator or arbitration tribunal, it may appeal to a court. It was reported that since

51. *Id.* art. 33.

52. *See* INTERPRETATIONS, *supra* note 28, at 81.

53. CONTRACT LAW, *supra* note 2, art. 35.

54. *Id.* art. 48.

September, 1983, arbitral tribunals for the settlement of economic contract disputes have been established at all levels of the Chinese government throughout the country. They have since then handled more than 63,800 cases involving more than 10 billion yuan.⁵⁵ This trend on the one hand reflects the Chinese tradition of avoiding litigation. On the other hand, it shows that arbitration is a more convenient means than litigation for the settlement of disputes. In fact, more than 70% of the disputes submitted to the arbitration tribunals were settled through conciliation or mediation.⁵⁶

The development of Chinese economic courts (which now number more than 1,000) has increased the possibility of effective settlement of disputes by the judiciary, as well as the attractiveness of an appeal to the courts in the event more informal dispute resolution is unavailing or one party is displeased with the arbitral award granted.⁵⁷

The Contract Law is silent on whether an economic loss or loss of profit should be compensated in case of breach of contract.⁵⁸ Nevertheless, interpretive notes by the Office of Economic Law Study Center of the State Council have pointed out that compensation for breach of contract should be sufficient to cover the actual losses and indirect losses to the non-defaulting party.⁵⁹ The interpretive notes, however, do not provide a definition of indirect loss. Chinese legal practice has not yet made a sharp distinction between a direct and an indirect loss.

IV. IMPACT ON CHINA'S LEGAL AND ECONOMIC SYSTEMS

The adoption of the Contract Law in China will have a major impact on China's economic and legal systems. With the adoption of the Contract Law, economic entities and farmers may now determine exactly what should be included in a contract, and what each party's rights and obligations are. In fact, by itself the adoption of the Contract Law is a major step toward improvement of China's legal system. Since contracts are being widely used in China, adoption of a substantive law of contract will help instill in the general public a more acute legal consciousness, which in turn will help the public understand and effectively enforce other laws.

The provision of explicit and specific standards for the formation and implementation of contracts will not only be helpful to the

55. Ren Min Ri Bao, Hai Wai Ban (The People's Daily), Jan. 12, 1985, at 2 (overseas ed.).

56. *Id.*

57. CONTRACT LAW, *supra* note 2, arts. 48 and 49.

58. *See id.* art. 35.

59. INTERPRETATIONS, *supra* note 28, at 83.

parties concerned, but also to courts and arbitration and mediation bodies. Those passing judgement will be able to follow the standards set in the law and give lesser credence to unwritten rules that contradict or are inconsistent with the written rules.

The emphasis on contractual rights and obligations under well-defined contract law will stabilize the legal relationship of the parties. It also impacts administrative orders, reducing their importance. Since state-owned entities and other types of entities must observe contractual obligations strictly, the implementation of the Contract Law will assist China in its general goal of running its affairs by law rather than by individual decisions.

The Contract Law is also important for the economic development of China. First, development of the Chinese economy depends on the plans adopted by the central government. At the same time, the effective implementation of the plans depends on cooperation and coordination between various entities, such as purchasers and suppliers, and manufacturers and end users. In order to achieve the desired harmonization, in pursuit of the goals set forth in the state plans there must be a link between the different economic entities. Contract can serve as this link.

Although China's economy is managed in accordance with state plans, the state plans usually are not very concrete. Rather, they provide general guidelines and final goals. The implementation of such plans is carried out by different economic entities entering into contracts based upon their respective understanding of applicable state plans. In sectors which are not regulated by state plans, such as service and farming, the significance of contracts may be greater than for sectors regulated by state plans. The central and local governments can assess the economic outlook in those sectors based on the contracts signed and make adjustments to related state plans. For instance, since 1978, production of cotton has not been under a mandatory state plan. Farmers have much latitude in setting their own levels of production. With good harvests, the government has sometimes been unable to purchase all the cotton the farmers want to sell, because of insufficient storage capacity. Starting in 1985, the Ministry of Commerce has asked its subordinate entities to sign contracts with farmers regarding purchases of cotton by the Ministry. More than 50 million contracts have been signed.⁶⁰ Based on those contracts, the Ministry knows the amount of cotton to be purchased in 1985 and has invested 500 million yuan in building storage facilities for cotton.⁶¹ Without the contracts, the

60. Ren Min Ri Bao, Hai Wai Ban (The People's Daily), Aug. 19, 1985, at 1 (overseas ed.).

61. *Id.*

Ministry would not have been able to estimate the amount it could purchase from farmers with such accuracy.

Second, the Contract Law will have an important effect on the efficiency of enterprises, either state-owned, collectively owned or privately owned. Under current policy, most state-owned enterprises bear economic losses and handle projects themselves. In order to manage its business smoothly and profitably, each enterprise must make certain that it has a continuing supply of needed material and that its products are needed by others. If these conditions are not met, an enterprise may go bankrupt.⁶² Contract provides a way of effectively calculating production costs and potential profits. Contracts can guarantee a continuous supply of materials and forecast the demand for a product.

Third, the Contract Law will help Chinese industries become specialized. Specialization is a natural outcome of industrialization. China is working wholeheartedly to modernize its economy. In the modernization process, many industries will become specialized. At the same time, they increasingly have to cooperate with each other. They must divide among themselves rights and obligations in the economic development program. Contracts will not only define their rights and obligations, but will also serve to ensure that each party will finish its own production plans in accordance with the terms of the contract. Specialization will therefore be stimulated.

Fourth, the Contract Law will help educate economic and administrative officers. Every contract requires detailed analysis of the source of materials, technology for production, quality, quantity and marketing of products. The process of negotiations, execution and implementation of contracts will undoubtedly help the administrators to better understand and manage their business.

Finally, contracts can be used to achieve certain special goals which may not be worked out by state plans. A good example is the curtailment of soil erosion. It would take tremendous efforts for the government to organize the people scattered in the countryside to prevent soil from being eroded. But with contracts, it can be done more simply. The Chinese government has signed contracts with 3.14 million households in the upper and middle reaches of the heavily silt-laden Yellow River. The contracts require each contracting household to take care of a given area of hillside land. The government has agreed under the contract to ensure them a share of returns from such service.⁶³ Money compensation is paid, any amount of which may be applied by a household to the purchase of food or fuel from the government, or retained as cash payment.

62. It was reported that 781 corporations went bankrupt in 1985 in Beijing. Guo Ji Ri Bao (International Daily News), Oct. 2, 1985, at 12.

63. China Daily, July 9, 1985, at 3.

These households are also exempted from agricultural taxes.⁶⁴ In return, the households have agreed to plant or preserve fruit and other trees on hillsides subject to the contracts. About 20 million hectares are concerned, almost equivalent to one-fifth of the country's cultivated land.⁶⁵ Similar contracts have been signed by farmers along the Yangtze and other major waterways across the country.⁶⁶

V. CONCLUSION

In conclusion, China does have a tradition of honoring contracts. The adoption of the Contract Law will add an important dimension to the process of improving the legal system in China, while helping the modernization efforts in the country.

64. *Id.*

65. *Id.*

66. *Id.*