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The Role of Contract Law in Developing the Chinese Legal Culture*

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I. INTRODUCTION

For nearly ten years China has been involved in an ambitious program of economic reform which affects virtually every aspect of Chinese life. Law has played a significant part in the reform process. Unlike developing countries which inherited colonial legal systems or formulated codes based on European precedents, China was faced with the task of developing a new legal system for regulating its domestic economy and for dealing with foreign trade.

Prior to the recent reform, China had made only limited efforts to establish a legal framework to regulate its domestic economy, but had made virtually no effort to codify the legal basis for relations between Chinese and foreign enterprises. The law did not play a very significant part in determining economic decisions. That began to change, however, when China surfaced from the cultural revolution and realized its economy must change. That transformation had two goals. First, China hoped to change the domestic economy and establish a foundation for its economic development. Its second goal was to change Chinese attitudes toward foreign investment. To accomplish these goals, China adopted laws that enabled it to improve relations with foreign companies and individuals and to improve the climate for foreign trade and investment.

Foreign businesses interested in investing in or trading with China understandably were concerned about the absence of laws. Consequently, China has adopted numerous laws in recent years to promote domestic economic development and to create a climate compatible with the development of foreign trade and investment. The Economic Con-

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tract Law (ECL)\textsuperscript{1} and the Foreign Economic Contract Law (FECL)\textsuperscript{2} are steps in the direction of greater legal certainty.

II. BACKGROUND

China has traditionally had a "tit for tat" attitude towards negotiating with foreign investors. This attitude stems from China's semifeudal, semicolonial history, during which China was dominated and exploited by foreign interests. Because of this history, the Chinese are understandably uneasy and suspicious at the bargaining table. More recently, however, the Chinese have found that a contractual relationship involves a commonality of interests.

III. ECONOMIC CONTRACT LAW

People have often questioned whether contract law is necessary in a socialist society in which producers, distributors, buyers, and sellers are all owned by the state. Nonetheless, it is clear that China needed a more comprehensive policy for economic regulation. In particular, laws allowing the enforcement of contracts were necessary to encourage factories to develop responsibility for their own production.

Economic reform has emphasized the accountability of factories for the results of their operations. The ECL constitutes a clear statement of the necessity for Chinese enterprises to observe economic contracts and thus contributes to the process of making every enterprise an independent accounting unit responsible for its own profits and losses. Without enforceable contract law there would be no adequate means of achieving this result.

The ECL also promotes a system of responsibility which is conducive to the development of trade by China's foreign trade organizations. For example, a Chinese import-export corporation will contract with a domestic enterprise on the basis of the ECL; a contract between the import-export corporation and a foreign enterprise will be subject to the FECL.\textsuperscript{3}

IV. FOREIGN ECONOMIC CONTRACT LAW

The FECL is the most significant legislation affecting foreign busi-
Role of Contract Law

tnesses dealing with China. It is a succinct but comprehensive statement of the law applicable to contracts between Chinese and foreign businesses. As such, it is the starting point for legal advice on Chinese-for-

Alien negotiations and agreements. A United States business considering entering into a contract with a Chinese organization should be interested in a number of aspects of the FECL.

A. Choice of Law

Chinese companies have been reluctant to accept foreign law in contracts. This is in part because of sensibilities about being subjected to the law of a foreign jurisdiction—an affront to sovereignty—and equally because of Chinese inexperience with foreign legal systems. On numerous occasions, the parties to contracts with Chinese organizations have agreed to leave the choice of law question open, leaving the resolution of disputes that arise from the contract for negotiation and possibly arbitration.

It is unclear whether article 5 of the FECL permits contracting parties to choose the law applicable to the contract. Literally, the section allows the parties only to designate the law applicable to "the settlement of disputes arising from the contract." Some Chinese lawyers have taken this provision to mean that the parties are free to choose the law applicable to the formation, performance, breach and enforcement of the contract, not merely the resolution of disputes. These practitioners believe that the applicable law can be at issue only when there is a dispute. According to this view, article 5 of the FECL means that foreign law may be adopted for all purposes relevant to the contract, unless the contract is one to which the application of Chinese law is specifically made mandatory.

Representatives of the Ministry of Foreign Economic Relations and Trade, however, have said that the language referring to dispute resolution was intentional. It would have been as easy to state that the parties "may choose the law to be applied to a contract" had this been the Ministry's intent. Read narrowly, article 5 means that the parties are authorized to choose the procedural law or rules of arbitration applicable in resolving a dispute. According to this reading, the court or arbitration tribunal might still be required to resort to the FECL to resolve issues concerning formation, performance, or breach. Consequently, foreign

4. Id. art. 5.
5. Id.
businesses must be aware of the requirements of the FECL even if the Chinese party agrees to apply foreign law.

**B. Formation**

The FECL adopts a flexible approach to the issue of contract formation. A writing is required, and the contract should contain certain items. While the FECL does not indicate whether a contract has been formed if one or more of the required elements is missing, a foreign business would be well advised to include at least the suggested items.

A more difficult problem is the provision that contracts requiring government approval are enforceable only when such approval has been obtained. Some guidelines describe which contracts must be approved by local authorities, which must be approved by national authorities, and which can be approved by the organization itself. There are also internal regulations which state that certain companies are not authorized to engage in buying or selling specific items and that all such business is limited to a specified company.

One approach which may alleviate confusion is to make independent visits to government agencies and try to obtain assurances about the requirements. While there are Chinese law firms which should help provide assurances, the firms appear to be just as puzzled as foreigners are about whether authority is required. One alternative is to have the Government approve the obligation of the Chinese party. There is a unique provision in the law which provides that if one of the parties is responsible for invalidity, that party will bear the responsibility for losses. Typically, if there is no contract, there is no liability. This provision, however, creates an independent quasi-contractual claim against the party if it was responsible for getting the approval and if the party misrepresented whether governmental approval was required.

Another problem is that many regulations are internal, or neibu, and, therefore, are by definition unavailable to foreign parties. Often the Chinese party will describe the neibu regulation, but the foreign party is at a clear disadvantage because it does not have access to the text of the regulation.

The process of using neibu is not intentionally deceptive. Nonetheless, a party is definitely put at a disadvantage when it agrees to some-

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6. *Id.* art. 7.
7. *Id.* art. 12.
8. See *id.* art. 7.
9. *Id.* art. 11.
thing and does not know the law. Thus, foreigners sometimes subject themselves to Chinese law before they even find out the nature of the law. It is recommended that if a foreigner agrees to the application of Chinese law, the contract should say that the foreign party agrees to be subject to Chinese law to the extent that the law is made known to the foreign party. Whether such a provision would be accepted, however, is an open question.

C. Performance and Breach

Enforceability is the key element of a contract in any legal system. The FECL states this obvious point, perhaps because of the laxity of "contracts" in China before reform.10

A foreign business will want to know whether the standards for performance established by the FECL are consistent with standards applicable to the foreign party's other commitments. For example, a United States importer of Chinese merchandise may contract to resell the merchandise to a United States purchaser. In that case, it may be important to know whether the provisions of the FECL are consistent with the Uniform Commercial Code.11

Careful attention must be paid to the importer's obligations vis-à-vis the Chinese supplier and to the importer's obligations to the United States purchaser. Similarly, the Chinese exporter may contract with another Chinese entity to supply the goods. The importer may be concerned about the ECL's impact on the ability of the Chinese exporter to perform.

Article 19 of the FECL contains a measure of damages for breach: the party that breaches the contract must compensate the other party for foreseeable losses.12 In several cases arising between domestic enterprises, Chinese mediation tribunals have refused to award the full amount of cover damages because the innocent party could have obtained substitute goods at a lower price. Nonetheless, it is an open question whether a Chinese tribunal would apply the same reasoning to a dispute between a Chinese and a foreign business. Another problem is determining the measure of damages if some goods are sold at a government-controlled price while comparable goods are sold at a free market price. Article 22 requires the nonbreaching party to mitigate damages.13 Another question

10. Id. art. 16.
11. Id. art. 17; U.C.C. § 2-609.
12. FECL art. 19.
13. Id. art. 22.
concerning mitigation of damages is whether the Chinese supplier should foresee whether the foreign party would cover from another Chinese source or from a foreign source. These issues remain unresolved and thus contribute to the unpredictability of negotiating commercial agreements in China.

Article 24 excuses breaches resulting from force majeure. Since government action may constitute force majeure, the parties should define carefully their respective responsibilities in the event of a change in government regulations or policy.

D. Settlement of Disputes

There is a strong preference on the part of the Chinese to settle disputes at the lowest level of confrontation. Although the FECL specifically contemplates arbitration in China or elsewhere, the foreign business should be aware of the reluctance of Chinese entities to litigate or arbitrate. In the final analysis, an arbitration award requires court enforcement which may be difficult to obtain.

V. CONCLUSION

The ECL and FECL have helped clarify the role of contracts in China's emerging legal system. The recently adopted civil code enhances this clarification. A United States business, however, should weigh carefully the impact of the FECL on any contracts it contemplates with China. When entering into a contract with a Chinese party, it is necessary to track the language of the FECL to insure there is a fully enforceable contract under foreign law or under Chinese law. It is also necessary to understand the relationship between the Chinese party and its domestic supplier in China. There are different sets of legal rules for each company in the production chain. The economic contract law between the import-export company and the Chinese supplier is important; the laws affecting the contract between the foreign company and the Chinese exporter are important; and laws of the foreign party's country may also play a vital role. The United States business should pay particular attention to the compatibility of obligations under the FECL with obligations under the laws applicable to United States domestic contracts.

14. Id. art. 20.
15. Id. art. 37.