

Studies on Certain Issues of the General Principles of Contract Law

Zheng Yunrui*

In the past thirty years, the economic and legal systems in China have undergone momentous changes. In concomitance with economic developments, the contract law has experienced a process of gradual development from the three former contract laws in the 1980s to the unified contract law at the end of the twentieth century. The newly promulgated contract law has absorbed successful legislative experiences and reflected international trends and developments in contract law. It unifies trade regulations, ensures trade security, encourages commerce and attempts to satisfy the developmental needs of the market economy to the maximum extent.

PREFACE

Thirty two years after the establishment of the People's Republic of China, the first contract law was promulgated: The Economic Contract Law of the People's Republic of China (hereinafter referred to as "Economic Contract Law").¹ Before this event, it is not that contract law did not exist in China, as it appeared through the form of custom and administrative regulations.² The Foreign Economic Contract Law of the People's Republic of China (hereinafter referred to as "Foreign Economic Contract Law")³ and the Technology Contract Law of the People's Republic of China (hereinafter referred to as "Technology

* Dr. Zheng Yunrui is an Associate Professor at the East China University of Politics & Law. This article has been translated by the students in the module of *Introduction to Chinese Legal Tradition & Legal Chinese* conducted in the Faculty of Law, National University of Singapore (2002/2003).

1 The Economic Contract Law was promulgated on the 13 December 1981, came into effect on 1 July 1982, and on 9 September 1993, the Bill of Amendment was passed by the Legislature.

2 See Guiguo Wang, *Wang's Business Law of China*, 3d. ed. (Butterworths Asia, 1999) at 45.

3 The Foreign Economic Contract Law was promulgated on 21 March 1985, and came into effect on 1 July 1985.

Contract Law”)⁴ were successively promulgated after the promulgation of the Economic Contract Law. During the times of economic transformation, those three former contract laws⁵ had great effect in protecting interests of parties concerned, maintaining order in commerce and developing the market economy. However, after entering the 1990s, the three former contract laws could no longer adapt to the need for legal reforms as required by social life. With the penetration of reforms, open door policy and the establishment of the market economy system, there were demands for the market transaction regulations to be unified, legal regulations and old civil law theories that reflected essential and special traits of the command economy system needed to be abolished and common regulations reflecting the objective principles of the modern market economy needed to be adopted. We have learned from the successful legislative experience, case law and theories of developed countries. Nineteen years after the promulgation of the first contract law, China promulgated the Contract Law of the People’s Republic of China (hereinafter referred to as “Contract Law”) on 15 March 1999, which took effect on 1 October 1999.⁶ Apart from this, in order to assist all levels of courts in understanding and applying the Contract Law, the Supreme People’s Court promulgated the Construction of Certain Issues Concerning the Application of The Contract Law of the People’s Republic of China (One) (hereinafter referred to as “Construction of Contract Law”).⁷ This article

4 The Technology Contract law was promulgated on the 23 June 1987, and came into effect on the 1 November 1987.

5 The three contract laws regulate different subjects. The Economic Contract Law applies to contracts concluded between Chinese legal persons, while the Foreign Economic Contract Law applies to contracts between Chinese legal persons and foreign legal persons, organisations or individuals. The Technology Contract Law applies to contracts that involve the object of technological development, transfer, information, and service as between Chinese legal persons, between Chinese legal persons and individuals, and between individuals. However, technology contracts signed between foreign legal persons, other organizations or individuals and Chinese parties are governed by regulations of the Foreign Economic Contract Law instead of those of the Technology Contract Law.

6 The Contract Law comprises of three parts: the general principles, specific provisions and supplementary provisions. It totals 428 articles. The law declares the abolishment of the Economic Contract Law, the Foreign Economic Contract Law and the Technology Contract Law. It ended the phrase of coexistence between the three-part contract law and unified the contract law regulations.

7 On 1 December 1999, during the 1090th meeting of the Supreme People’s Court Tribunal, the Contract Law Construction (Legal Interpretation [1999] No. 19) was passed. The legal construction was put in force by a proclamation on 29 December 1999. It contains seven parts and a total of thirty provisions. It mainly regulates the sphere of applicability of contract law, limitation of actions and effectiveness of contracts. The two kinds of rights: the right of subrogation and the right to rescind serve as measures to protect obligee rights.

undertakes a preliminary comparative analysis of three aspects of the general principles of Contract Law.

I. TAKING EFFECT OF CONTRACTS

The system of the formation of the contract and the system of the taking effect of the contract are closely related. The formation of the contract refers to the meeting of minds.⁸ Looking at the manner of the formation of the contract, the mode of a contract's formation is by offer and acceptance.⁹ No matter what specific form the formation of the contract takes, it needs to undergo the two stages of offer and acceptance. This is the basic procedure for contract formation and it is also the general *modus operandi* for international contract formation. In fact, the process of offer and acceptance is the process of the meeting of minds of the contracting parties. The conclusion of the process of offer and acceptance indicates the unanimous accord of the interests of the parties, thus declaring the formation of the contract. Before the promulgation of the Contract Law, General Principles of the Civil Code, three former contract laws, and relevant contract laws and administrative regulations, lacked the stipulated requirement of offer and acceptance. Under many situations, the lack of a system of offer and acceptance results in difficulty of determining whether or not the contract is formed, and may cause an originally formed contract to be adjudged as not formed. The requirement in Contract Law of the system of offer and acceptance may result in a more concrete standard in contract formation. This will result not only in contractual parties engaged in commerce having remedies to resort to, but also in the courts having definite and clear established principles when dealing with contractual disputes, having better demarcation of the parties' responsibilities, correctly judging the contract's formation, sufficiently safeguarding the party rights, encouraging commerce, and promoting economic development. Therefore, offer and acceptance are of vast significance in the formation of the contract.

The taking effect of the contract refers to an already formed contract producing a binding force in law between the parties. The taking effect of the contract refers to the affirmative evaluation of the already formed contract by the national law. The formation of the contract is a question of fact and is a matter between the contracting parties;

8 See also Zhao Xu Dong, *Lun He Tong De Fa Lu Yue Shu Li Ji He Tong De Cheng Li Yu Sheng Xiao: Discussion On The Legal Binding Force And Effectiveness Of Contracts And The Formation And Taking Effect Of Contracts* Vol. 1 (Chinese Law, 2000).

9 Article 13, Contract Law.

however, the taking effect of the contract involves value judgment. Whether or not a contract takes effect depends not only on whether the expressed intentions were common and true, but also on whether or not the parties possess the corresponding civil capacities, whether or not the contract's operation or content harms third parties or state or public interests, and whether or not the form of the contract corresponds to mandatory provisions in the law.

The difference between the formation of the contract and the taking effect of the contract is not clearly expressed in the Economic Contract Law. Similarly, in the General Principles of the Civil Code and the Foreign Economic Contract Law, it is also in an obscure and vague state. An example is that apart from Article 6 of the Economic Contract Law which regulated that "economic contracts formed in accordance to the operation of law possess binding force in law", no other provisions refer to the question of the taking effect of the contract. Hence, the question of the taking effect of the contract is concealed. However, after looking at Article 62 of the General Principles of the Civil Code which states, "Conditional civil juristic acts come into effect when it conforms to the condition", the difference between formation and taking effect starts to show in civil juristic acts. Nevertheless, whether it is due to the insufficiency of theoretical proof or due to a mistake in legislative technique, this important problem merely shows up preliminarily in the general principles of civil law and the demarcation of boundaries has not been further clarified. Therefore, this caused some contract laws to define approval from authorities as an essential element in the formation of a contract, while others define the above mentioned approval as one of the essential conditions for the taking effect of a contract. This contradiction and conflict between different contract laws is scarcely unexpected.

Not only does this problem exist in China's contract legislation, it also causes a great deal of confusion in judicial practice and jurisprudential study. The contract law academe places more emphasis on the study of the taking effect of a contract; however it neglects the study of the formation of a contract. Some civil treatises mix the issues of a contract's formation and taking effect and quite a number of treatises just equate the essential conditions of the taking effect of the contract with that of the formation of the contract. With such interconnectedness, pronouncements of contracts being ineffective can be found everywhere in the judicial practice, while examples on judgments about a contract not being formed are extremely rare.¹⁰

10 Wang Jia Fu (Main Editor), *Zhong Guo Min Fa Xue • Min Fa Zhai Quan: Chinese Civil Law Study • Civil Law Creditor Rights* (Law Press, 1991) at 314.

According to civil law theory, the essential conditions of the taking effect of a juristic act refer to “juristic acts that are already established, essential matters that makes the abovementioned acts completed effectively”.¹¹ The essential conditions of the taking effect of a contract can be divided into normal conditions and special conditions. The former can be applicable to various juristic acts, the latter is only applicable to certain special juristic acts. The contents of the normal conditions for taking effect include four main areas:¹²

- a. The parties should possess the corresponding legal capacity and capacity to act when concluding a contract;
- b. The expressed intentions of the parties are true;
- c. The contract does not contravene the law or public interests; and
- d. The contents of the contract must be definite, possible, legal and appropriate.¹³

Through comparisons, it could be seen that the conditions of a contract and the conditions of the contract’s taking effect is a sort of “external-internal” relationship. As long as the parties have a meeting of minds, the contract is formed. This is an external representation. However, it is only when parties who have fulfilled specific conditions, or made representations that fulfil special requirements, would the formed contract have legal effect. These types of conditions are legally required for the taking effect of the contract; they are its “essence”. Therefore, contracts that are already formed need not necessarily have legal effect, while a contract that has come into effect must already be formed. The setting up of two equally important standards of conditions for formation and conditions for taking effect to regulate juristic acts is to give effect to legislative intent. On one hand, the parties make offers and acceptances with the aim to create the contract, therefore, the law does not make many regulations with regards to the formation of the contract, its largest extent being to satisfy the expectations of parties and to conform to the principle of the autonomy of parties’ will; on the other hand, due to certain trends in social values, recognition in law of a contract should necessarily be strictly regulated in order to prevent contracts that seem harmless on the face of it, but whose actual contents are harmful, from taking effect.

The system of approval and registration of contracts is closely related to a contract’s formation and taking effect. According to laws

11 Shi Shang Kuan, *Min Fa Zong Lun: Civil Law Pandect* (China University of Politics and Law Press, 2000) at 324.

12 Article 55, General Principles of Civil Law.

13 Shi Shang Kuan, *supra*, n 11, at 326–34.

and legal regulations, some require the relevant government department's approval or the registration of formalities. With regards to the legal effect of such approval or registration, is it a matter of the formation of the contract or a matter of the taking effect of a contract? The Contract Law does not resolve this question. From China's past contract law legislation, it can be seen that there are completely different legislative attitudes towards the legal effects of act of approval or registration. In the Foreign Economic Contract Law, the act of approval is prescribed as a condition for the formation of a contract. Article 7 of the above mentioned law states, "when contracts that should be approved by the country are given approval, the contracts are regarded as formed". The Technology Contract Law also prescribes acts of registration as conditions for the formation of a contract since Article 10 states, "(contracts) that require approval from the relevant authorities according to state law are formed from the date of approval". However, two months after the promulgation of the Foreign Economic Law, in May 1985, the State Council released the Technology Introduction Contract Governing Regulation, Section 20 of which prescribes that technology introduction contracts "come into effect on the date of approval". Before that, in January 1982, the State Council released the Foreign Cooperative Exploitation of Ocean Crude Oil Resources Regulation where Section 6 also prescribes that contracts for crude oil come into effect when given approval. Hence, approval becomes a condition for the taking effect of a contract. In other words, state laws prescribe acts of approval and registration as conditions for the formation of the contract while the State Council's regulations determine these as conditions for the taking effect of a contract.

The Contract Law distinguishes the formation and the taking effect of the contract, but does not demarcate the legal effects of approval and registration.¹⁴ Under Article 44 of the Contract Law, there will be no problems if laws or regulations clearly state that approval or registration is a condition for the contract to take effect. However, when laws and regulations only prescribe the need for approval or registration procedures, and do not prescribe whether the procedures are conditions for the formation of the contract or conditions for the taking effect of the contract, how do we ascertain the legal effects of approval or registration? Looking at the articles regarding the formation of a contract in contract law, questions that do not involve

¹⁴ Article 44 of Contract Law states, "According to the above mentioned regulation, law and administrative regulations should handle taking effect procedures relating to approval and registration."

approval or registration seem to reflect the inclination to view approval and registration as conditions to the taking effect of the contract and not to the formation of the contract. However, due to the ambiguity of this article, it cannot remove the possibility that future laws and regulations would follow the precedent in the foreign economic contract law and the technology contract law in deciding that approval or registration goes towards the conditions for the formation of a contract. However, the judicial construction by the Supreme People's Court affirmed that acts of approval and registration go towards the conditions for the taking effect of the contract.¹⁵

According to the general principles of civil law, the essential condition for the formation of contract is the mutual consent of both parties, as such there is no need for approvals and registration as a basis for the formation of contract. A contract is the result of an agreement between the parties and is the embodiment of the principle of freedom of contract. As long as both parties adhere to the contractually stipulated regulations on offer and acceptance, and the terms of contract are consistent with the fundamental provisions, or alternatively if the contract conforms to the circumstances provided by articles such as article 37 of the Contract Law, then the contract is established. It is thus clear that the formation of a contract is a matter purely within the scope of the parties, and is unrelated to the law, the state agencies or even third parties.

The same, however, cannot be said for the taking effect of the contract as that is where a contract acquires its legal enforceability, and therefore, it is not merely the intentions of the parties that are relevant. It certainly includes the State will, the state's adjudication and acceptance of the acts of the parties. Thus it is impossible that the law should vest legal enforceability in a contract that clearly violates legal requirements. Both the requirement of approval and registration are forms of contractual intervention by either the State will or external factors. The requirement of approval is a reflection of an administrative act of the State will, the purpose being to interpose on the private lives of individuals through the power of the State. At the same time, it allows for contractual relations that are in accordance to the interests of the party and which also are in keeping with the State and public interests. Registration is a special procedure handled by a statutory body and its purpose is to allow the legal relations between the specific parties to gain the effect of fairness and credence that is publicly recognized. The requirements of approval and registration do not entirely constitute the essential conditions to the formation of

15 Article 9, Construction of Contract Law.

a contract, rather, they are used to determine whether the contractual objectives of the anticipated contract can be realized by the State mandate, thereby achieving the expected civil legal result. This is, in fact, the issue that the system which governs the coming into effect of a contract has to address.

II. PERFORMANCE OF CONTRACT

The performance of a contract is where an obligor performs his contractual obligation and the obligee realizes his contractual claim, thereby extinguishing the relationship between creditor's rights and liabilities.¹⁶ With regards to the issue of contractual performance, the Contract Law draws widely references from foreign contract law systems. For example, it draws reference from regulations such as the right to demur when adversely affected,¹⁷ and the right to demur for a subsequent performance¹⁸ and specific performance etc.¹⁹

Before the promulgation of the Contract Law, a severe gap in Chinese contract law existed with regards to the preservation of creditor's rights.²⁰ Even though judicial interpretation refers to the obligee's right of subrogation, it is merely restricted to the procedure of civil action and does not involve the substantive law at all.²¹ In order to

16 See also Xie Huai Shi, et al., *Hetong Fa Yuanli: Principles of Contract Law* (Law Press, 2000) at 143.

17 Articles 68 and 69, Contract Law.

18 Article 67, Contract Law.

19 Article 110, Contract Law.

20 For a detailed discussion on the issue of preservation of contract: see also Wang Li Ming, Cui Jian Yuan; *Hetong Fa Xinlun • Zongze: New Theory on Contract Law • General Rules* (China University of Politics and Law Press, December 1996 ed.), at 375–402.

21 In the Supreme People's Court, *Guanyu Shiyong (Zhonghua Renmin Gonghe Guo Minshi Susong Fa) Ruogan Wenti De Yijian: Concerning the Application of The People's Republic of China's Civil Procedural Law – Questions and Opinion* as stipulated in article 300, is the theory of basic compliance to the obligee's right of subrogation but the major limitation of the provision lies in the fact that its usage is confined merely to the enforcement process of civil litigation, causing its legal functionality to be severely compromised. As such, the significance of the system of an obligee's rights of subrogation is certainly not absolute or complete.

When the Supreme People's Court enacted the *Guanyu Guanche Zhixing (Zhonghua Renmin Gonghe Huo Minfa Tongze) Ruogan Wenti De Yijian (Shixing): About Thorough Enforcement [The General Rules of People's Republic Of China Civil Law] Questions and Opinion (Trial Implementation)*, according to the principle of obligee's right to rescission, art. 130 provides that: 'where a donor who for the purpose of evading his legal duty to perform his obligation, tries to grant his assets to others to dissipate it, such granting of assets will be void if an interested party alleges his claim. Unfortunately, this article merely provides for circumstances where the obligor tries to escape his obligation and it is restricted to only the conduct involving gratuitous transfer of property. Its scope of application being very narrow, it thus cannot constitute a complete system of the obligee's right to rescission. As such, before the promulgation of Contract Law, in the Chinese Civil Law did not have a complete system for the preservation of an obligatory right.

remedy the legislative gap, the Contract Law provides for the system of preservation of contractual claim, more precisely, it provides for the system of the obligee's right of subrogation and rights of rescission.²² An obligee's claim or right to rescind, through the use of the obligor's assets as a guarantee and the objective of the system of preservation of obligatory right is founded upon the circumstances where the inappropriate dissipation of the obligor's assets results in the obligee's inability to realize his claim. The system of the obligee's right of subrogation is mainly to give due regard to the obligor's nonfeasance, whereas the obligee's right to rescission is to give due regard to the positive acts of the obligor. The systems of an obligee's rights to subrogation and rescission are a breakthrough with regards to the principle of the 'relativity of contract'. In the conventional contract law, the legislative foundation for such systems is founded on the guarantee of the realization of obligatory rights.

A. *Right of Subrogation (dai wei quan)*

The right of subrogation refers to where an obligor, in delaying his exercise of his right against a third party, jeopardizes the realization of the obligee's contractual claim. In order to protect the realization of his claim, The obligee can, by way of using his own name in place of the obligor, exercise his right.²³ For instance, Company B owes Company A £1,000,000 in debt which is due on 12 October 2001, Company C owes Company B £800,000 in debt which is due on 10 October 2001. On or after 12 October 2001, Company B has neither repaid Company A its due obligation nor has it instituted a lawsuit or by way of arbitration take positive measures against Company C for the repayment of the debt in question. As such, according to the system of the right of subrogation, Company A can use its own name in place of Company B to demand that Company C discharge its obligation that was due.

1. *The Constitutive Conditions of an Obligee's Right of Subrogation*

These are:²⁴ Firstly, as between the obligee and obligor, there must be an existing legally binding relation of contractual right and obligation.

²² Articles 73–75, Contract Law.

²³ See also Li Yong Jun, *Hetong Fa Yuanli: Principles of Contract Law* (People's Republic of China Gong'an University Press, 1999) at 401. Cui Jian Yuan, Han Shi Yuan, *Hetong Fa Zhong De Zhaiquan Ren Daiwei Quan Zhidu: The System of the Obligee's Right To Rescission In The Law of Contract*, in *Zhongguo Faxue: China's Jurisprudence* (3d. ed., 1999).

²⁴ In the understanding the constitutive elements of the obligee's right to subrogation, it is important to note that a balance should be struck between the two target values

Due to the fact that an obligee's right of subrogation is an accessory right, created out of the need to protect an obligee's claim, if between the obligee, who exercises his right of subrogation, and the obligor there is no existing legally binding, valid and affirmative contractual relation of rights and obligation, the obligee would lack the basis for his exercise of his right of subrogation. Secondly, the obligor must have been delayed in the performance of his obligation and had been tardy in exercising his due claim against his sub-obligor. This means that the obligor neither performs his contractual obligation that is due to the obligee nor does he, by way of lawsuits or arbitration, take active measures to the monetary claim that is due to him against his sub-obligor. First and foremost, regardless of whether it is the obligee's contractual claim against the obligor, or whether it is the obligor's contractual claim against the sub-obligor, both should be contractual claims that are due. The obligor must have not performed his obligation to the obligee that is already due, nor must he have initiated his rights to his claim against his sub-obligor.²⁵ Also an essential condition is that the obligor's inactivity must have caused damage to the obligee.²⁶ But judging from the actual provisions of Contract Law, it seems that the obligor's delay in performance is not a necessary condition, but from a reasonable perspective, Contract Law should rely on the obligor's delay in performance as a constitutive condition for the exercise of the right to subrogation and this should be restricted to where the obligee has suffered damage from the delay in performance of his due claim. In the Construction of Contract Law, it is further affirmed that that the obligor's delay in performance should be a constitutive condition for the right of subrogation,²⁷ and this explanation is favorable to the striking of an equilibrium of the beneficial

of safeguarding the security of transactions and respecting the freedom of intentions of the parties. In other words, even if the obligor does not take positive action to carry out his obligation so much so that it impedes the realization of the obligee's claim, the obligee can nevertheless easily invoke his right of subrogation as he pleases, which can be detrimental to the interests of the obligor and the third party. If the mandatory effect of the claim is allowed to enlarge indefinitely, not only will it cause the principle of relativity of contract to collapse, it will also cause the obligor to be enslaved to the obligee as a result of the existence of the contractual relation. As can be seen from the provisions of Construction of Contract Law, articles 11, 12 and 13, the Supreme People's Court has severely confined the conditions of the application of rights of subrogation.

²⁵ Article 13 of Construction of Contract Law has definitively determined that the obligor's delay in performance (including obligor's non-performance of his due obligation to the obligee) as an important constructive condition for the right of subrogation. The legislations in most civil law countries basically consider a delay in performance as an important condition for deriving the right to subrogation.

²⁶ Article 73, Contract Law.

²⁷ Article 11, section 2, Construction of Contract Law.

relationship between the obligee and obligor.²⁸ In addition, when exercising his right against the sub-obligor, the obligor must do so by way of either filing a lawsuit against the sub-obligor or by arbitration. Lastly, the obligor's entitlement against the sub-obligor must involve a monetary payment or a claim of debt.²⁹ Thirdly, the obligor's conduct must have caused damage to the due obligation of the obligee. The obligor's tardiness in the performance of the obligee's due obligation and his non-claim for the due creditor's rights must have caused the obligee's due claim to be unrealized.³⁰ Fourthly, the obligor's obligation is not exclusive to the obligor's personal rights.³¹ As the interest of the object of subrogation, not only is it restricted to the obligor's claim against the sub-obligor, it must also not be a personal right belonging exclusively to the obligor.³²

28 Before the obligor actually is in delay of performance, it is difficult to anticipate whether an obligee's rights can be realized. Under circumstances like these, to allow the obligee to exercise his right of subrogation would be a gross interference of the obligor's affairs. The law will not unduly subject the obligor to the enslavement of the obligee, so that the obligor would be totally under the control of the obligee, merely because the obligor has an obligation towards the obligee. This emphasizes the fact that the law no doubt has provided for the protection of the obligee's interests, but on the other hand, it had neglected the obligor's freedom of conduct. The law should thus strike a balance of tension between the two and such balance is known as the 'period of delay of performance'. Before the expiration of the period of performance for the discharge of the obligation, the obligor possesses freedom of economic conduct, he could perform his obligation at his will or find other means to discharge his obligation. During this time, the obligee cannot willfully interfere with the conduct of the obligor until the expiration of the period of performance. If however, the obligor continues in non-performance of his obligation and even delays in his performance, and having no financial means to discharge his obligation thereby causing the obligee's claim to be unrealisable, at this point then it would not do to continue to vehemently argue for the value of the 'obligor's economic freedom'. Rather, one should argue for the protection of obligatory rights from the perspective of the 'protection of the obligee's interests' and thereby accord the obligee with the right to subrogation.

29 The reason for limiting the purported obligatory right to the monetary obligation is to ease the application of the new system of right to subrogation and also to raise the efficiency of lawsuits. This is because the sub-obligor's obligation to the obligor is via the delivery of goods and providing of services, and does not involve payment of cash. This will in turn cause problems and trivialities in litigation. On the whole, it creates more complications and even causes situations where there is a supervening impossibility of performance, thus the reason for obligatory right in a monetary claim.

30 The specific criterion for judgment is generally that based on an obligor's inability to repay. If an obligor has a strong financial capacity, even if he does not duly perform his obligation and even delays in performing his obligation, thereby causing a reduction in the total assets, he will not endanger the realization of the obligee's right. This is as long as the obligor's assets is still sufficient to discharge his obligatory right to the obligee and the obligee is left to exercise his right of subrogation by petitioning to the court to impose a mandatory enforcement on the obligor.

31 Article 11, section 4 and article 12, Construction of Contract Law.

32 Generally speaking, there are four types of rights that belong exclusively to the obligor: First, non-proprietary rights. This mainly refers to rights relating to the personal status as an individual, for example, guardianship right, right to petition for

2. *The Method of Exercising the Right of Subrogation by the Obligee*³³

It is clearly stipulated in the Contract Law that the obligee's exercise of his right of subrogation can be carried out by way of legal action.³⁴ The reasons for legal action in the exercise of right of subrogation are: Firstly, it is only through adjudication that it can be ensured that those obligees who exercise their rights of subrogation can obtain a benefit, and that the benefits are reasonably distributed among the obligees. Secondly, the exercise of right of subrogation by way of adjudication can effectively prevent certain obligees from abusing their right of subrogation and thereby avoid confusion caused by civil circulation actions. Thirdly, it is effective in preventing disputes from arising, by providing that the only method to exercise the right of subrogation is by way of legal action. It can help prevent the conflict between the obligees who use the prescribed method to institute their right of subrogation and those obligees who resort to direct measures. In addition, it can effectively resolve the conflicts between the obligee and the obligor, and issues relating to the sub-obligor which are caused by the exercise of the right of subrogation.

3. *Issues on the Validity of the Right of Subrogation*

The validity of the right of subrogation involves the obligor, the third party and the obligee himself. With regards to the obligor, once the obligee has started exercising his right of subrogation and had notified the obligor of such, the obligor is not to jeopardize the obligee's disposition of his interest in the exercise of his right of subrogation, nor is he to abandon, absolve or assign or conduct himself in a manner that would erode the validity of the exercise of the right of subrogation. The benefit of validity in civil law that is created by the obligee's exercise of right of subrogation should go directly to the obligee. As

divorce, right to claim of legitimate children, etc. second, for the purpose of protecting the intangible benefits of property of the obligee. For example, the recognition of inheritance, bequeathal, or rights to abandonment, right to maintenance, right to petition for the compensation for damages due to the infringement, impairment of one's life, health, reputation, freedom etc. third, the right not to alienate. This mainly refers to the obligatory rights arising from fiduciary relations or relationship or special status or that are intimate, right to abstention etc. fourth, right not to be detained. For example, remuneration for labour, pension moneys, retirement moneys, relief moneys and pension for the disabled etc.

³³ With regards to the exercise of the rights to subrogation, in each country's legislation and the practice realm, there exist 2 types of methods, litigation and direct measure of enforcement. The Japanese civil law prescribes that one can discharge a monetary claim by the method of litigation or arbitration or to protect the right of admittance via direct measure. Chinese Taiwan local civil law has yet to expressly provide for it and in reality, the obligee is free to choose from either of the two methods.

³⁴ Article 73 section 1, Contract Law.

to third parties, the obligee's exercise of his right of subrogation is equivalent to the obligor's exercise of his claim against them. At the same time, after having exercised the right of subrogation and notifying the obligor, the right of defence as against the obligor that the third party acquired, can now be used to counter the obligee's claim. Such defences include the act of God and the extinction of an action. As to the obligee, the necessary expenses expended as a result of the exercise of the right of subrogation can be claimed by way of restitution against the obligor. Upon the reversion of the entitlement of the obligor, the obligee can make use of the proceeds from the realization of the assets to discharge his own claim. When the sub-obligor has performed his obligation to discharge himself from the obligor's claim, and the obligor still has claims from other obligees, the obligee who exercised his right of subrogation and the other obligees' claims are on par with all other claims and the obligees are all on the same standing. The obligee who exercised his right of subrogation would not have priority over the other obligees in his claim.

The Contract Law does not provide for the validity of the right to subrogation but the Construction of Contract Law remedied this inadequacy of the law of contract. Firstly, with regards to the validity on the obligor, once the obligee institutes a legal action against the sub-obligor to establish his right of subrogation, and with the court having heard and affirmed the right, the right of subrogation is then established. The sub-obligor will have to discharge his obligation to the obligee, and then the corresponding claim and obligations between the obligee and obligor, and between the obligee and sub-obligor will be extinguished.³⁵ Regardless of whether the obligor is himself exercising his right of claim or the obligee is exercising his right to subrogation, its effect on the sub-obligor and on the obligor's claim against the sub-obligor does not have any impact on the legal status or interest of the sub-obligor. As such, a sub-obligor can make use of whatever right of defence that he is entitled to use against the obligor to subsequently counter the claim of the obligee.³⁶

Lastly, with respect to the validity of the obligee's claim, he cannot, when enforcing his subrogation right, request for an amount that exceeds the monetary scope of the obligor's liability. The obligor must bear the necessary costs for the obligee's enforcement of subrogation rights.³⁷

³⁵ Article 20, Construction of Contract Law.

³⁶ Article 18, section 1, Construction of Contract Law.

³⁷ Article 74, Contract Law.

The regime of the right to subrogate is concerned with balancing the interests of both obligee and obligor, and with protecting the autonomy of will and the principle of good faith. The original rationale in establishing the regime for subrogation rights is to protect obligations, stabilize obligatory relationships, insist on the principle of who should claim and who should gain, benefit the obligee when he protects his obligation actively, simplify the procedure for protecting obligations, and raise the efficiency level for protecting obligations. In establishing the regime for subrogation rights, an important aim of China's Contract Law is to solve China's real and rampant problem of "Three-way debts". Whether this regime can in fact fulfil this goal depends on the correct interpretation by academics. Modern experiences from foreign jurisprudence and doctrines also need to be absorbed, together with the use of judicial practice, to give this regime real spirit.

B. *Right of Rescission (che xiao quan)*

The right of rescission refers to the obligee's right to ask the Court for rescission where the obligor has acted to the prejudice of his obligation. Compared to the subrogation right of the obligee under the regime for preservation of obligatory rights, the effect of rescission is stronger, because when the obligee subrogates to enforce the obligor's present right, his influence is minor, whether to the obligor or the sub-obligor. However, when he rescinds the obligor's conduct to recall property subject to the liability, the damage he causes to an established legal relationship creates a major impact. Thus, theoretically, the conditions for enforcing rescission should be restricted strictly to avoid upsetting the security of transactions. However, Contract Law stipulates that the right of rescission is limited only to three situations where the obligor's conduct is prejudicial to the obligation, such as where the obligor renounces obligations that are due, and where he transfers property to third parties gratuitously or at prices that are so low as to be obviously unreasonable.³⁸ For example, Company A owes Company B a debt of £500,000 and due to poor management, only a BMW is left of the company's assets. Company A sells the BMW that is worth £600,000 to a friend, C, for £200,000. According to the regime for rescission of rights, Company B has the right to recall the BMW from C because Company A's conduct, in dealing with the BMW, has directly harmed the rights of Company B, and has led to its inability to realise the obligation. However, if Company A has sufficient assets

³⁸ Article 74, Contract Law.

to repay the obligation that is owed to Company B, A's disposal of the BMW is valid and Company B cannot make use of the regime of rescission to recall the BMW from C.

The following are elements for rescission by the obligee: Firstly, the obligee must have an effective obligation against the obligor. The existence of an effective obligation against the obligor forms the prerequisite and foundation to the obligee enforcing his right of rescission, and the aim of such a right should generally be the payment of property.³⁹ Secondly, the obligor must have performed certain acts to dispose of property. When the obligor disposes of property, Contract Law restricts the remissibility of such acts to where the obligor renounces his obligatory rights and where he transfers property to third parties gratuitously, or at prices that are so low as to be obviously unreasonable.⁴⁰ Thirdly, the obligor's acts must be prejudicial to the obligation. As the obligor's act leads to a decrease of his financial ability to discharge his obligation and a disability to satisfy its demands, such prejudice to its realisation forms an important criterion for determining the obligee's rescissory right. In setting up a regime for rescission, contract law aims to ensure total discharge of the obligor's obligation by preserving the property that is subject to liability, reflecting an inclination of modern civil law towards strengthening contractual reliance to protect the obligee's interest.⁴¹ Fourthly, malice is not a condition for rescission of gratuitous conduct, that is, rescission can be enforced both with and without malice. However, malice is a condition for rescission of conduct that provides consideration. Malice involves knowledge that one's actions may cause or increase the disability to discharge one's obligation and so prejudice the obligee's rights, that is, damage the obligee's interests severely. Without such recognition, there can be no rescission. When the obligor recognizes that his conduct prejudices the obligation but believes that it can protect the obligor's rights, such conduct can also

39 With regards to whether the redemption period must be exceeded before the right of rescission can be enforced, the legislation and doctrines of different countries have given different interpretations. German civil law stipulates that the time period for performance of the obligation must be exceeded, while common teachings in France and Japan opine that the obligatory right need not have exceeded its time limit to enforce rescission rights. In China, Contract Law and judicial interpretation of the Supreme People's Court have not set down legislation with regards to this question.

40 Article 74, Contract Law.

41 Rescission aims to restore the property of the obligor that is subject to liability and not to safeguard his ability to hand over specific subject-matter. Thus, as long as the obligor's transfer of the specific subject-matter leads to a decrease in property and the lack of repayment ability, or it prejudices the obligatory right, the obligee can enforce his right of rescission; in other words, there is no question about the rescissory right itself.

be rescinded. Thus, the obligor's malice comprises two situations, that of intention and negligence. The malice of the enriched party can reveal his malicious collaboration with the obligor; it can also show his engagement in civil conduct with the obligor despite knowing the latter's malicious intentions. It is irrelevant whether the enriched party knows of this malicious intention before or during his enrichment. If the enriched party has no malicious intention, the recessionary right generally cannot be enforced. This is to protect the interests of a *bona fide* third party, especially as his conduct provides consideration. Disposal of property at prices that are obviously too low should be considered disposal with consideration, and both the obligor and the enriched party must possess subjective elements.

With respect to conduct that provides consideration, such as the obligor transferring property at such low prices that are obviously unreasonable, both the obligor and third party must possess malice. The obligor's malice is the condition for establishing rescission, while the enriched party's malice is the condition for enforcing rescission.⁴²

The obligee's right to rescind destroys the legal relationship between the obligor and the third party. A long-term failure to enforce the rescissory right places the relationship between the obligor and the third party in a long-term unstable state, and is disadvantageous towards protecting the interests of the obligor and the third party. Thus, Contract Law stipulates that the right to rescind is extinguished if such right is not enforced one year from the date on which the obligee knows or ought to know of the matter subject to rescission, or within five years from the date on which the obligor performs the relevant act.⁴³ The Supreme People's Court interprets the period for rescission of contract as an "unchangeable period" (*bu bian qi jian*),⁴⁴ where the rules for limitation of action—suspension, discontinuance or extension – are not applicable.⁴⁵

The obligee must enforce the rescissory right in his own name and bring an action in the People's Court to seek rescission of the obligor's unjust disposal of the property. In addition, the scope for enforcement of this right is limited to the extent of the obligor's obligation. With regards to the scope for enforcing recessionary rights, basically, two

42 See Shi Shang Kuang, *Zai Fa Zong Lun: The Pandect on the Law of Obligation* (China University of Politics and Law Press, 1999 ed.) at 473, for the civil procedural law in China on who asserts the claim and who adduces the evidence. The obligor bears the burden of proof in showing that the transfer of property was reasonable.

43 Article 75, Contract Law.

44 Article 8, Contract Law.

45 With regards to the nature of this period, the civil codes of each country reveals different judicial attitudes, some stipulate it as limitation of action, while some as removal of repulsion (*chu chi qi jian*).

views exist: when numerous rights are prejudiced by the conduct of the same obligor, the first view deems that each obligee has the right to sue for rescission, the scope of their claim being limited only by the sphere of protection for each individual obligatory right.⁴⁶ The other view opines that since enforcement of rescission aims to protect the properties of all parties, the scope of this enforcement is not limited to protecting the value of the rights that the obligee enforces, but should extend to the protection of all the rights of all the obligees.⁴⁷ However, the judicial interpretation from the Supreme People's Court has limited the scope for enforcing subrogation rights to each obligee's extent of protection of his right.⁴⁸

C. *Right to Demur when Adversely Affected (bu an kang bian quan)*⁴⁹

After the formation of a bilateral contract, if the party who is obliged to perform first has concrete proof that the other party cannot, or has the possibility of being unable to, perform his contractual obligations, he can exercise his right to demur when adversely affected. This refers to the right, as seen in the above situation, to reject performing one's contractual obligations first before the other party performs or provides a guarantee.

The following conditions establish the right to demur when adversely affected:⁵⁰ Firstly, both parties in a bilateral contract must have mutual payment obligations. The right to demur when adversely affected can only take effect in a bilateral contract, just like the right to demur for concurrent performance (*tong shi lü xing kang bian quan*). Secondly, there must be a chronological order for performance of the contract, whereby one party performs first while the other performs later. If there is no chronological order in the parties' performance,

46 See Yang Li Xin, *Guan Yu He Tong Fa Zhong De Zhai De Bao Quan Wen Ti: In Relation to the Question of Protection of Obligations in Contract Law*, in *Fa Xue Qian Yan: The Forward Position of the Law* (2d. ed.) at page 28.

47 See Wang Jia Fu, *supra* n 10, at 186.

48 Article 25, Construction of Contract Law.

49 The right to demur in law is the right of resistance (*dui kang quan*) to impede the opposite party from enforcing his right. The standard is based either on the effect of enforcing the right to demur, or on the postponement of the effect of the opposite party's right to demur. The legal right to demur is categorized as permanent (extinguished) right to demur or delayed (temporary) right to demur. The former is represented by the right to demur that arises upon the expiration of a prescription, while the latter is represented by the right to demur for concurrent performance and the right to demur when adversely affected.

50 Article 68, Contract Law. The applicable conditions for the right to demur when adversely affected, that is stipulated by the law of contract in China, has rather significant differences from the rules of other civil law countries, that is, it is more lenient, having adopted the related regulations in the "United Nations Convention on International Sale of Goods".

then the right to demur for concurrent performance may arise instead of the right to demur when adversely affected. Thirdly, the party who should first perform the contract must have concrete evidence to prove that the party who should perform later has lost, or may lose, the ability to perform after the formation of the contract. This involves three elements: (1) the later-performing party loses or may lose his ability. (2) The later-performing party loses or may lose his ability to perform his obligations after formation of the contract.⁵¹ (3) The first-performing party bears the burden of proving the facts. In asserting his right to demur when adversely affected, the first-performing party must have concrete proof that the other party has lost or may lose the ability to discharge the contractual obligations, he cannot rely on his own subjective speculations.

In enforcing the right to demur when adversely affected, the first-performing party can suspend his performance, but he should inform the other party and give a reasonable time limit for the latter to recover his ability to perform or to provide a suitable guarantee. The act of suspending performance is lawful and does not amount to breach of contract. If the party who should perform later is unable to provide a guarantee or recover his ability to perform within the reasonable time limit, and still requests the other party to perform, this first-performing party can refuse to perform. If the later-performing party is able to provide a guarantee or recover his ability to perform within the reasonable time limit, the first-performing party should continue his performance of the contract.⁵² This fully reflects the temporary nature (*yi shi kang bian quan*) of the right to demur when adversely affected.

However, the right to demur when adversely affected in Contract Law clashes with the provisions in Article 94, section 2 of the same statute.⁵³ As Contract Law did not stipulate clearly the conditions under which the latter provision is applicable, it thus applies to both situations of concurrent performance and sequential performance. When one party expresses clearly that he will not perform his obligation, the other party can use Article 94, section 2 to enjoy directly his

51 Two different legislations exist in various civil law countries with regards to when the property of the later-performing party has to decrease evidently. The first is an obvious decrease in property after the formation of the contract, the second is a decrease already at the time the contract is formed, such as Rule 165 in Austria's Civil Code.

52 Article 69, Contract Law

53 Article 94 of Contract Law stipulates: a party can repudiate a contract when one of the following situations occur: ... (2) Before the time period for performance ends, one party expresses clearly, or shows evidently with his conduct, that he will not perform the main obligation; ...

right to repudiate the contract. However, when a party shows evidently with his conduct that he will not perform the main obligation, his conduct can be interpreted as: an expression of non-performance of the obligation; or the loss, or probable loss, of his ability to perform the obligation. In the former situation, the other party can repudiate the contract directly; but in the latter situation, the other party can only enjoy the right to demur when adversely affected. He can suspend his performance of the contract and request the opposite party to provide a performance guarantee, but he has no right to repudiate the contract directly. The emergence of two different operative methods in the same statute has led to a contradiction in the application of the law. If the first-performing party is allowed to elect to apply Article 94, section 2 of Contract Law, the likelihood of situations where he abuses the right to repudiate the contract is high. The substance of the regime for the right to demur when adversely affected- protection of the legal interests of the later-performing party-will thus deteriorate and prejudice the expectation interest of the later-performing party.⁵⁴

D. *The Right to Demur for Concurrent Performance*
(*tong shi lü xing kang pian quan*)

The right to demur for concurrent performance refers to both contracting parties performing the obligations owed to each other at the same time. The request for this right can be rejected prior to the performance by the requesting party or during the performance if it is not according to the stipulations agreed upon.⁵⁵

The following conditions establish the right to demur for concurrent performance—Firstly, the parties have to be mutually obligated by virtue of a bilateral contract. This right springs from the principle of fairness derived from the mutually dependent nature (*qian lian xing*) of a bilateral contract. Therefore, this is not applicable to unilateral contracts and bilateral contracts which are not complete or genuine. The mutual obligations of the parties must be borne out of one single contract. The right will not arise if the mutual obligations are borne out of two or more contracts even if the parties share an intimate relationship in reality. These obligations must be owed directly to each other. There must also be a connection between the obligations themselves.⁵⁶ For example, if A sold a car to B and bought

54 See Wang Li Ming, *Yu Qi Wei Yue Zhi Du De Ruo Gan Wen Ti: The Regime for Prospective Breach of Contract—Some Questions* (Law Press, 1999 ed.).

55 Article 66, Contract Law.

56 See Su Jun Xiong, *He Tong Yuan Ze Ji Qi Shi Yong: The Principles Of Contract Law and Its Application* (San Ming Bookshop) at 111.

£500,000 worth of raw materials from him, two separate contracts are formed. A cannot refuse to hand over the car simply because B has not passed him the raw materials. This is because there is no connection between the handing over of the raw material and the handing over of the car. Secondly, parties must complete the performance of their obligations at the same time. This is to fulfill the aim of the right to demur for concurrent performance, which is to ensure that both parties can enjoy the benefits of completion of performance at the same time. If the nature of the contract is such that the date of completion for both obligations are different, or that it is stipulated within the contract as such, the first-performing party cannot impose this right when the other party has not completed the performance of his obligation. Thirdly, the other party must have failed to perform his obligation or performed it out of accordance with the agreed stipulations. To request for the right to demur for concurrent performance, the requesting party must have already fulfilled its own obligation owed to the other party. This fulfillment has to be in accordance with the agreed stipulations within the contract. If the performance of one party is delayed, partially flawed or in any way contrary to the contract, can the other party apply for the right? If a party who has not completed the performance of its obligations, requests the other party to fulfill his obligation, can the latter party use the right to demur for concurrent performance?⁵⁷ According to Contract Law, one party has the right to reject the request for fulfillment of obligations if the requesting party did not comply with the stipulations agreed upon during performance.⁵⁸ Fourthly, the obligations must be such that they are capable of being performed. If the obligations are no longer capable of being performed, the purpose of the right to demur for concurrent performance—that of realizing both obligations at the same time—will not be met. Consequently, no problems relating to this right will arise. As such, the contract shall be discharged according to the relevant legal provisions.

57 If performance by one party is partial or flawed or unsuitable for performance, the other party still can file for pleading. No problems relating to pleading will arise if one party has already embarked on proper performance. Wang Jia Fu, *supra* n 10, at 403.

58 If one party requests for performance without notifying the other party that it has already fulfilled its obligation, the latter (the accused party) will be disadvantaged in the event that the performance does not comply with the contract, such that it is delayed, unsuitable or flawed etc. This is unfair to the accused party which will not get to enjoy the requesting party's performance, or it can only enjoy performance which is contrary to the contract. Wang Li Ming, *Wei Yue Ze Ren Lun: Responsibility arising from breach of contract* (China University of Politics & Law Press, 2000 rev. ed.) at 267.

The advantages of the right to demur for concurrent performance are a balance of interests between the parties, protection of their rights, preservation of normal transaction procedures, enhancement of the co-operation between parties, guarantee for the performance of the contract and protection of the legal interests of the parties.⁵⁹ The legal basis of this right is the mutually dependent nature of bilateral contracts, whereby the existence of the parties' obligations and benefits are dependent on each other and that cause and effect are mutually reliant. This dependency is reflected in three areas. First, in the formation of contract, where two opposing obligations, with mutually dependent conditions, arise from the same contract. When one obligation can no longer stand, the other obligation will similarly be rendered ineffective. This dependency is also shown when the performance of one's obligations is conditional upon another's. Therefore, if one party fails to perform, the performance by the other party will inevitably be affected. Finally, in the existence and continuation of dependency, the problem of liability arises if, without the fault of either party, the contract is rendered incapable of performance.⁶⁰ The pre-requisite to effect this right lies in the consequences brought about by dependency.

E. *The Right to Demur For Later Performance*
(*hou lü xing kang pian quan*)

In a situation where the first-performing party fails to perform, due either to delays or serious flaws (in his performance), the other party can refuse to perform his counter-obligation in order to protect his interest. This is the right to demur for later performance. Of course, this system can only operate in accordance with the terms of the contract or legal provisions. This right belongs to the class of suspended rights (*yan qi kang bian quan*) and can only prevent the opposing party from exercising his right of claim on a temporary basis; it is not a permanent right (*yong jiu kang bian quan*). Once the earlier party fulfills its obligations, this right extinguishes and the latter has to fulfill its obligation. The earlier party is to be held responsible for the breach of the contract, either by delayed or non-substantial (incomplete) performance.

The theory of China's law of contract only includes regulations concerning the right to demur for concurrent performance and the

59 See Wang Ze Qian, *Ming Fa Jue Shuo Yu Pan Lie Yan Jiu: Research On Civil Doctrine And Case Studies*, Vol. 5 (China University of Politics & Law Press, 1997 ed.) at 146.

60 See Wang Li Ming and Cui Jian Yuan, *supra* n 20, at 335-336.

right to demur when adversely affected. It does not provide for regulations pertaining to the right to demur for later performance. The system of the right to demur for later performance is established after Contract Law adopted the relevant regulations in the International Commercial Contract Rules.⁶¹ This has great impact on both theoretical discussions and practical applications. The doctrine helps to distinguish the problem arising from breach of contract by one party and that arising from both parties by demarcating the parties' responsibilities. It is commonplace in judicial practice that one party breaches the contract first, leading to the other party to terminate performance in order to protect his legal interest. In such a situation, the court will normally rule that both parties are in breach and subsequently, both will be held responsible. This is not only unfair to the latter party, it is also too lenient in dealing with the former party's act of breach. This is where the right to demur for later performance steps in. It clearly reflects the right—obligation relationship between the parties involved—where one party's breach leads to the termination of performance by another, helping to identify the nature of the parties' conduct and responsibilities arising from the breach.

The requirements for the right are as follows—first, the contract has to be a bilateral one and there must be in existence a relationship between the casual obligations of both parties. Unilateral contracts such as donation contracts will not lead to problems relating to the right. Secondly, there must be a chronological order for the performance of obligation. This order can be determined by regular course of dealing, such as the payment of hotel fees only after staying and the purchase of tickets prior to boarding a plane or train. Thirdly, the latter party can only request for this right if the other party fails to perform or performs contrary to the contract. For example, if it is stipulated in the contract that payments will only be made upon delivery, the buyer can refuse to make the payments prior to the delivery of goods.

Both the right to demur for later performance and the right to demur when adversely affected occur during the course of performance and are aimed at protecting a party's rights from being infringed. However, the right to demur when adversely affected can only be used by the earlier party while the right to demur for later performance is for the exclusive use of the later party. The right to demur when adversely affected operates on the basis that there is a risk that there will be no performance while the right to demur

61 In both the German Civil Code and Japanese Civil Code, there are no regulations relating to the right to demur for later performance.

for later performance is applicable only when the breach has already been objectively established. For the right to demur when adversely affected, the party needs to notify the other party so as to give the latter a chance to adduce evidence or provide a guarantee. For the right to demur for later performance, there is no such need as the opposing party has already committed a breach, therefore, a pleading can be filed immediately.

The later-performing party has to take notice of the temporal nature of the right to demur for later performance. Once the first-performing party fulfils his obligation, this right will be extinguished and the later-performing party will also have to fulfil his obligation. Otherwise, his actions may constitute a breach. The establishment of this right completes and enhances the system for the right to demur when adversely affected by balancing the interests of the parties and raising fairness and justice to a higher notch.

III. LIABILITIES IN CONTRACT LAW

Liabilities in contract law refer mainly to pre-contractual obligation, liability for breach of contract and post-contractual obligation.⁶² This extension of responsibility results in parties being burdened by all three kinds of obligations. However, this extension in the Chinese law of contract is inevitable in the face of rapid development, leading to the adoption of the system and regulations which are used by many other countries in the world.

A. *The Extension of Contractual Obligations*⁶³

In traditional theory relating to contract law, the responsibility taken on by the parties is solely that stipulated by the parties (also known as the obligation to pay). However, in modern times, the emphasis has shifted to the realization of obligatory rights. Therefore, to ensure this, contractual obligation is no longer restricted to that agreed upon in the contract as it now includes incidental obligation. This

62 Pre-contractual obligation relates to the start of negotiation to just before the completion of contract. The period relating to liability for breach of contract is from the date the contract comes into effect, till the completion of it. Post-contractual obligation refers to any incidental obligations, even though the contract has been completed and the contractual relationship extinguished. Therefore, pre-contractual obligation occurs prior to the existence of the contract, post-contractual obligation occurs after the completion of the contract while the liability for the breach of contract is in the middle of these two.

63 The argument for extension of contractual obligation can also be found in the United States and United Kingdom, see R.A. Hillman, *The Richness of Contract Law* (Kluwer Academic Publishers, 1997) at 23–32.

obligation is based on honesty and regular course of dealing, which requires parties to do the necessary preparations in order to ensure the realization of obligatory rights. Care must be taken too, to ensure protection of one's rights such as body, health and wealth throughout the whole contractual process. By incorporating such theories, regulations regarding intentional obligations, such as the requirements of notice, aid and confidentiality, are introduced into Chinese contract law.⁶⁴ Regulations pertaining to pre-contractual⁶⁵ and post-contractual obligations⁶⁶ are also introduced, thereby extending the scope of Chinese contract law.

IV. PRE-CONTRACTUAL OBLIGATION

From the traditional view of civil law, parties will only take on obligations after the conclusion of the contract. This is so even if parties have started negotiating. It is thought that if obligations are imposed while negotiating, it will severely curtail the freedom of negotiation. However, the modern approach in civil law is that even if the contract is not concluded, there is still an existing obligation if mutual reliance between the parties springs from mutual interaction and negotiation. Pre-contractual obligation comes about at the stage of negotiation, whereby one party causes the other to be reliant on it and as a result suffer damages (whether intentionally or negligently). The former will be liable for the damages caused and the negligence in the making of the contract.⁶⁷ In Article 42, the stated situations whereby one party has to be liable for the damage caused include—(1) There is no genuine conclusion of contract and negotiations have been entered into maliciously; (2) Certain material facts relating to the conclusion of the contract are intentionally hidden from the other party or that

64 Article 60, Section 2, Contract Law.

65 Articles 42 and 43, Contract Law.

66 Article 92, Contract Law.

67 Liability for negligence in the making of a contract was suggested by the German scholar Yelin and developed by German case law. This has profound impact on China. Article 61 of Civil Rules states, "When a civil action is deemed to be ineffective or rejected, the party which has derived property due to this action will have to return it to the damaged party. This will be akin to damages given by the liable party to compensate the loss suffered by the other party. As both sides are at fault, they should bear their respective responsibilities." Article 16 of Economic Contract Law reflects the same principles in the case of a commercial contract. Therefore, academics suggest that the regulations in both Civil Rules and Economic Contract Law include this liability for negligence in the making of a contract. Zhou Da You and Duan Xian Yi, *He Tong Ze Ren Zi Du Chuang Xin Tan Suo: New Explorations into the system of Contractual Obligations*, in *Tan Suo: Exploration* Vol. 6 (1999). Certain articles in Contract Law such as Articles 42 and 43 adopted regulations from PICC and PECL, refining the regulations relating to pre-contractual obligations and liability for negligence in the making of a contract.

false information is given; (3) Other acts of dishonesty. Article 43 states, "The trade secrets that one party gathers in the course of establishing the contract cannot be revealed or used for improper purposes, regardless of whether the contract is eventually concluded successfully or not. If damage is caused to the other party due to the revelation or improper use of trade secrets, it will be borne by the party who caused it.

The liability for negligence in the making of the contract is based upon pre-contractual obligation which is in turn derived from the principles of honesty and trust. According to the traditional approach, prior to this negligence, a party can only make use of the law of infringement and not the law of contract. However, the contractual relationship is one that is based on trust, and this legal relationship between the parties arises when the parties concerned enter into negotiations with the intention of making a contract. When this happens, the relationship changes from an ordinary to a special one, and as a result, a special trust relationship is formed. The nature and strength of this kind of relationship goes further than most obligations required in tort law and is relatively closer to that of contract.

The conditions constituting liability for negligence in making a contract are: When the parties liaise with each other with the intention of entering into a contract and one party violates the pre-contractual obligations, the liability for the occurrence of damage will be attributed to the party who violates the pre-contractual obligations. Furthermore, Chinese law does not require the opposite party to be non-negligent. If the opposite party is also negligent in the occurrence of damage, then "each will bear the corresponding liability".

On the question of liability for negligence in making a contract and the liability to compensate for damage, it is quite controversial whether the injured party may request that the performance interest or reliance interest be used. The commonly held view is that the damages for negligence in making the contract is based on the principle of reliance interest, while the damages for performance interest is not recognized. As to whether the damages for reliance interest can exceed that based on the principle of performance interest, there are views saying no⁶⁸ and views that say yes.⁶⁹ With regards to damages for reliance interest, some academics claim that the rule of foreseeability can be suitably used to limit such damages.⁷⁰

68 See Cui Jian Yuan, *Di Yue Shang Guo Shi Ze Ren Lun: Doctrine of Liability for Negligence in Making a Contract* (University of Jilin Social Science School Paper, 1992) Vol. 3.

69 See Zhang Guang Xing, *Zhai Fa Zhong Lun: General Doctrine of the Law of Obligations* (Law Press, 1997) at 56.

70 See Liang Hui Xing, *Min Fa: Civil Law* (Sze Chuan People's Press, 1988) at 144.

V. POST-CONTRACTUAL LIABILITY

Post-contractual liability arises from the violation of post-contractual obligations, i.e., certain obligations with regards to an act or omission when the contract has ended that the parties will still bear in special circumstances, in accordance with the principle of good faith. This is to preserve the personal and proprietary interests of the opposite party and if in violation of the said obligations one should bear the corresponding liability. After the contract has ended, it is not as though the parties no longer have any relationship. The parties should abide by the principle of good faith and carry out the obligations of notification, providing assistance and confidentiality, etc. in accordance to the customary practice.⁷¹ If one has obtained the other party's technical secrets, marketing channels etc. through the contractual relationship, they should be kept confidential. After the termination of an employment contract, when one party goes to work for the competitor of the original unit, he should not use the technical secrets etc. of the original unit on his own accord. Another example is that when there are technical problems in the operation of the supplied machine facilities, the supplier should provide the buyer with technical support and assist in overcoming difficulties. These are the requirements of the principle of good faith.

Post-contractual liability is a form of contractual liability that was not provided for in the previous three separate law of contract. Contract Law only stipulates post-contractual obligations, but does not provide for post-contractual liabilities. Article 92 of the Contract Law stipulates: "When the rights and obligations of the contract has ended, the parties should abide by the principle of good faith and carry out the obligations of notification, providing assistance, confidentiality, etc. in accordance to the customary practice." However, after this section, there is no corresponding section on the liability for violating post-contractual obligations. This is a lacuna in enacting the law. However, one should not infer from this to conclude that the Chinese law does not include post-contractual liability as part of contractual liability. First, stipulating obligations imply that there is liability. It should also be understood that in not performing the post-contractual obligations, one would incur post-contractual liability. Second, in providing for a section on "Liability for the breach of contract" in Part 7, after

71 For most cases, incidental obligations arise from and are based on the principle of good faith and it is present at various stages of the contract; from when the parties negotiate and conclude the contract to the time the rights and obligations of the contract are carried out etc. The parties should bear the main incidental obligations of providing assistance, notification, confidentiality, etc of the contract.

stipulating post-contractual obligations in Part 6, it should be understood that the sections on liability for the breach of contract can be used to regulate the behaviour for violating post-contractual obligations. Therefore, it is justifiable to treat post-contractual liability as constituting part of the liability for contracts in China.

The main elements constituting post-contractual liability, from the time it occurs, should be such that when the performance of the contract has ended, one party did not carry out the obligations of notification, providing assistance, confidentiality, etc., and the aforesaid conduct causes damage to the other party, and there is a causal link between the behaviour and the resulting damage. Furthermore, to constitute post-contractual liability, the wrong-doer must be objectively at fault. There can be no damages if there is no fault. Of course, in proving that the party is at fault, fault deduction should be used. If the wrong-doer is asked to prove that there is fault, it is most likely that there will be no fault.

A. *The Principle of Attributing Liability in the Breach of a Contract*

With regards to the principle of attributing liability in contract liability in China, before the enactment of Contract Law, there are the following three views held by Chinese academics:⁷²

First, the principle of attributing contractual liability is based on the principle of fault liability. This view of monism of the principle of attributing contractual liability is widely acknowledged by the academic. The obligor is at fault for not carrying out his obligations and this is a pre-requisite condition for bearing liability for the breach of contract.⁷³ Due to the special nature of contractual liability, the monism of the principle of attributing liability and the principle of fault liability in contractual liability is the principle of fault deduction.⁷⁴ Second, the principle of the objective attribution of liability and the principle of non-fault liability, and not the principle of fault liability, should be used for contractual liability. As long as the obligor violates the obligations that was agreed upon in the contract, it does not matter whether there is objectively no fault. He still has to bear the civil liability.⁷⁵ Third, contractual liability and the principle of

72 See Wang Li Ming, *Wei Yue Ze Ren Lun: Liability in Breach of Contract* (China University of Politics and Law Press, 1996) at 54.

73 See Xie Bang Yu, *Min Shi Ze Ren: Civil Liability* (Law Press, 1991) at 107.

74 See Wang Jia Fu, *He Tong Fa: Contract Law* (China Social Sciences Press, 1986) at 481.

75 See Jin Xiao, "Guo Cuo" Bing Fei Wei Yue Ze Ren De Yao Jian: "Fault" is not the main element of liability for breach of contract (Learning Law, 1987) Vol. 3.

attributing liability should be based on dualism, and not on a single principle of attributing liability. Other than the dual principles of attributing liability in contractual liability and the principles of fault and non-fault liability, the contract law in China also has an existing system of the dual implementation of the principles of fault and non-fault liability.⁷⁶ However, there are different opinions on the limits of the principles of fault and non-fault liability when they each apply.⁷⁷

After the enactment of Contract Law, the academic felt that Contract Law stipulates non-fault liability and strict liability.⁷⁸ Strict liability has obvious and easily identifiable advantages.⁷⁹ Firstly, the plaintiff need only prove to the court the fact that the defendant did not carry out his contractual obligations. The plaintiff is not required to prove that the defendant was at fault. Strict liability also does not require

76 See Cui Jian Yuan, *supra* n 68, at 73.

77 See Wang Li Ming, Cui Jian Yuan, *supra* n 20, at 54.

78 See Liang Hui Xing, *Cong Guo Cuo Ze Ren Dao Yan Ge Ze Ren: From non-fault liability to strict liability*, in *Min Shang Fa Lun Cong: Theories of Civil and Commercial Law*, Ch. 8 (Law Press, 1997) at 4–5. Cui Jian Yuan, *Yan Ge Ze Ren? Guo Cuo Ze Ren? : Strict Liability? Fault Liability?*, in *Min Shang Fa Lun Cong: Theories of Civil and Commercial Law*, Ch. 11 (Law Press, 1997) at 190–197.

79 Strict liability is the direction of the development in contract law. Two major legal systems have adopted different principles in attributing liability with regards to breach of contract. The Chinese legal system has adopted the principle of fault liability with regards to most contractual liability while the English and American system has adopted the principle of strict liability.

Article 114 of the France Civil Code states: “Whenever the obligor cannot prove that the reason for not carrying out the obligations arises because the responsibility should not be attributed to the individual, even if the individual is bona fide, the obligor should, if necessary, pay the compensatory damages for not performing or delaying the performance of the obligations.” Article 275 of the German Civil Code states: “The obligor should bear liability for negligence, whether intentional or not, unless otherwise provided.” Even if in the recently amended Taiwan Civil Obligations, the principle of fault liability for contractual liability is affirmed. Article 220 of the German Civil Code stipulates: “The obligor should bear liability for his negligent conduct, whether intentional or not.”

Looking at the relevant international conventions, the United Nations Convention on International Sale of Goods and the Unidroit Principles of International Commercial Contracts both adopted the principle of strict liability. Article 108 of the Principles of European Contract Law provides: “If the non-performing party proves that the non-performance is caused by an obstacle that cannot be controlled, one cannot reasonably expect him to be able to foresee the said obstacle at the time the contract was made, or to avoid or overcome the obstacle or its consequences, then he should be forgiven for not performing.” If the United Nations Convention on International Sale of Goods is said to have adopted the principle of strict liability because of the influence of the Anglo-American Law, then the Unidroit Principles of International Commercial Contracts and the Principles of European Contract Law in adopting the principle of strict liability, should be regarded as the consensus reached by the leading respected academics of two major legal systems after much debate, and reflects the common trend in the development of contract law.

From the perspective of the relevant legislature of China, the General Principles of Civil Law and the Foreign Economic Law has adopted the principle of strict liability, but the Economic Contract Law adopts the principle of fault liability.

the defendant to prove that he was not at fault for not performing. Thus, the difficulty of proving whether there is fault is done away with and judgment is also facilitated. It is also beneficial to the economy of the proceedings. Secondly, there is a direct relationship between the liability for non-performance and breach of contract as there is a causal link between the both of them. Strict liability helps in ensuring that the parties treat the contract seriously and it also adds to the gravity of the contract. The tendency of the party in breach to try and argue that there was no fault, hoping to escape liability and to avoid being under the principle of fault liability helps in strengthening the spirit of responsibility and the legal awareness of the parties.⁸⁰ Contractual liability is used as an important measure to guarantee the realization of the rights and obligations. The main effectiveness lies in its compensatory nature and the assurance that the obligee can or may get compensation from the obligor's property for all the damages incurred as a result of the non-performance of the obligations. At the same time, contractual liability also has the function of guarding against non-performance of obligations. There is no doubt that replacing the original resulting liability with the principle of fault liability is an improvement. However, its effectiveness is not complete. The biggest shortcoming in contract law is that it provides the contract breaker with relatively more opportunities to escape liability and it makes it more difficult for the obligee to obtain relief. The principle of strict liability gets rid of the main elements of fault, limits the ground of pleading and makes it easier to establish liability. From this, the obligee can obtain relief and it also maximizes the embodiment of the compensatory function of contractual liability. Furthermore, strict liability is more satisfactory to the innate quality of liability for the breach of contract. There is a difference in the inherent quality of liability for infringement and liability for breach of contract. The logic for abiding by the former is that since the conflict of rights commonly exists, the occurrence of damage is unavoidable. The law requires the person whose conduct was infringing to bear the liability, and the occurrence of the damage should not be the pre-condition. The attribution of liability is such that there should be reasons other than the fact that there was damage. The basis for the attribution of liability is fault. Due to the existence of fault, it makes the pursuing of most infringement liabilities more reasonable and persuasive. Liability for

80 See Cui Jian Yuan, *Hai Xia Liang An He Tong Ze Ren Zhi Du De Bi Jiao Yan Jiu: The Comparative Research of the Regime of Contractual Liability in China and Taiwan* (Student Paper of University of Qinghua, 2000) Vol. 2.

the breach of contract is different as it arises from contractual obligations. The innate quality is that it comes from the agreement of both parties and is not imposed by law. The law upholds the binding force of the contract, pursuing the liability for breach of contract when there is non-performance, but it is only carrying out the intention of the parties. Therefore, liability for breach of contract is relatively stricter, and should be stricter than most liabilities for infringement.

Fault does not constitute the main element in order to establish strict liability. One should bear the liability for violating a contract. Comparing that liability with fault liability in such a situation, it is very strict, but this does not mean that there is no possibility of any exemptions from liability under the system of strict liability. Even if it is a strict liability, it is not absolute and there are possibilities of exemptions from liability. The possibility of this kind of exceptions refers to cases where the defendant proves the grounds for the exoneration from liability. Under the system of strict liability, *force majeure* is a direct stipulation of the ground for an exemption from liability. Once you prove that there is *force majeure*, you are exempted from liability. However, under the system of fault deduction or fault liability, *force majeure* is used as evidence for proving that one party has no fault. Once you prove *force majeure* under the system of strict liability, you will be exempted from liability because it is stipulated as an exception to strict liability by the law. *Force majeure* is the same under the two systems, the only difference is in the technique of applying it. Under the system of strict liability, if the parties have stipulated an exemption clause and agreed on a clause that limits liability, in principle, these clauses are still valid. In reality, there is not much difference between strict liability and fault deduction liability. Strict liability is, however, not equivalent to absolute non-fault liability.

CONCLUSION

From the decision of the National People's Congress to begin enacting a uniform law of contract for China in October 1993 was made to the enactment of the contract law, the time taken was six years. The draft of the Contract Law differs from the previous enactments of other laws in that it fully utilized the contributions of academics. The academics actively participated in the drafting exercise of this Contract Law. Furthermore, judges also participated in this legislative exercise of the law of contract. Therefore, Contract Law not only reflects the standard of research and theories in China's contract law, it has absorbed and drawn inspiration from the principles and systems of market economy's common practices. It is also a reflection that China's judicial

practice has a relatively adaptable nature. The general principles of Contract Law are the essence of contract law and have an important status in contract law. The general principles of Contract Law stipulate the basic principles and the basic systems of the formation and taking effect of contract, the performance of the contract, the liability of the contract, etc. Before unifying the contract law, China's enactment of contract laws and judicial practice did not separate the systems of formation and taking effect of the contract. It should be an improvement that the Contract Law separates the systems of formation and taking effect of the contract. Looking at comprehensive problems of a contract, the system of the right of rescission and the right of subrogation may provide a system of security for the obligee to realise his obligatory rights and it also sets the foundation for the system of a good market order. During the performance of the contract, there are all sorts of regimes for the rights to demur, it covers the different stages of the performance of the contract as a whole, balancing the relationship in the interests between the parties, embodying the rationale of fairness and justice in law. The development of liability in contract law also reflects the legalisation of moral principles. It does not matter if it is pre-contractual liability or post-contractual liability; all it embodies is the principle of good faith in contract law. The principle of attributing liability in contractual liability reflects the common trend in the development of contract law in this area.

However, the law of contract in China has not reached a level of perfection. Like the general principles of contract law, all kinds of problems still exist, and it awaits further research in academic theory and judicial practice to supplement it and to bring it to a higher level.