

FREEDOM OF CONTRACT UNDER STATE SUPERVISION

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I. INTRODUCTION: THE THEORETICAL INCOHERENCE OF FREEDOM OF CONTRACT AS A LEGAL TRANSPLANT

It has been said that Western private laws are similar in nature even when the technical rules are different.¹ This is because they share the same philosophical origins that provide similar inherent principles. Also, the increasingly globalized economy has promoted the unification of private laws, especially in the context of commercial law. Even non-Western jurisdictions have adopted Western laws in order to show the world that they comply with international standards and that it is safe for Western investors to invest heavily in these countries where they can expect legal protection like that of their home jurisdictions. Even if the technical rules and the written sources are the same, laws can be different if the rules are applied in societies that are structurally different. As Rodolfo Sacco pointed out in his seminal article, *Legal Formants, A Dynamic Approach to Comparative Law*, “The statutes are not the entire law. The definitions of legal doctrines by scholars are not the entire law. Neither is an exhaustive list of all the reasons given for the decisions made by courts.”² Nevertheless, although the rules may function differently, there are universal values any system would like to preserve. Such values include the

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¹ See generally James Gordley, *Is Comparative Law a Distinct Discipline?*, 46 AM. J. COMP. L. 607 (1998) (noting that, although the technical rules are different, relief given by Western courts may be much the same); James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587, 1627 (1981) (noting that France, Germany, England, and the United States allowed a party to an unfair contract to obtain some degree of relief). See generally E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 239-40 (1987) (arguing that though there is no general duty to negotiate in good faith in America, courts impose similar duties as European courts would).

² Rodolfo Sacco, *Legal Formants: A Dynamic Approach to Comparative Law*, 39 AM. J. COMP. L. 1, 27 (1991).

preservation of party autonomy, fairness, and minimization of the more informed party's exploitation over the less informed.

Since late 1990s, the idea of freedom of contract has gradually become acceptable in Chinese society. In 1999, it was established as a fundamental principle of Chinese contract law code.³ The legislature, leading jurists, and the Chinese Communist Party all shared high expectations for the utilitarian advantages of freedom of contract in an emerging market economy, particularly by encouraging domestic and cross-border commercial dealings. In their opinion, China is heading towards market socialism and, as a result, freedom of contract in China will be as it is envisioned in Western contract theories, paradoxically, since these theories have been in controversy for the past century in the West.

Since the early 1990s, Chinese economic reform has signaled a transition from a planned economy to a market economy and the use of the market to allocate resources.⁴ The autonomy of the will, as it figures in Western contract theories, has been regarded as the "soul of private law."⁵ It has been argued that "freedom and openness" should replace the "the paternalistic and restrictive nature" of Chinese law.⁶

Both the formal legislative sources from the National People's Congress and two major drafters of the Contract Law code, Jiang Ping and Wang Liming, considered freedom of contract essential to the market economy.⁷ They believed that freedom of contract should be embraced to the fullest extent in order to limit the government's intervention and narrow the role of state plans, despite objections to that idea raised by Western legal theorists in the 20th century. Wang Liming emphasized the importance of freedom of contract in two of his articles introducing the new statute to the West:

Respect for the freedom of contract of market actors is a precondition of market economic development. As the freedom enjoyed by contracting parties broadens, the flexibility and self-governing nature of the market will be

³ See [Contract Law of the People's Republic of China] (promulgated by the Presidential Order No. 15, effective Mar. 15, 1999) art. 4.

⁴ See Jiang Zeming's Report at 14th Party Congress (Mar. 29, 2011) (declaring the establishment of a market economy in China and use of market mechanism to allocate resources), http://www.bjreview.com.cn/document/txt/2011-03/29/content_363504_4.htm.

⁵ 江平 张礼洪[Jiang Ping & Zhang Lihong], 市场经济和意思自治 [Market Economy and Autonomy by Parties' Free Will], 法学研究 [6 LEGAL STUDIES], at 21 (1993).

⁶ See *id.* at 22.

⁷ See 孙礼海 [Sun Lihai], 合同法立法资料选 [Selective Legislative Materials on Contract Law] 4, 5, 法律出版社 [Law Press].

strengthened. Transactions will be promoted and, with the development of the market, society's wealth will be increased. Therefore, freedom of contract is a basic and necessary condition for the development of transactional relationships under market economic conditions. Any contract law that regulates transactional relationships should adopt freedom of contract as its fundamental principle.⁸

The position was seconded by another prominent Chinese civil law scholar, Jiang Ping. According to Jiang, "to accord parties freedom of action to the greatest extent possible is the common demand by the market economy and the autonomy of the parties' free will."⁹ Both Jiang and Wang agreed that there is a proportional correlation between the extent of parties' freedom to exercise their wills and the dynamics of the market economy.¹⁰ Unlike contemporary Russian civil law that limits the freedom of the parties to conclude a contract,¹¹ Chinese law embraces all aspects of freedom of contract and allows parties to enjoy freedom in the formation, validity, terms, termination, and choice of remedy of their contract.¹² The voluntariness principle in previous laws limited freedom of contract only to the formation of contract and imposed mandatory rules on other aspects of contracting.¹³ Now, in virtually all aspects of contracting, previously mandatory rules have given way to the mutual agreement of the parties.¹⁴

The practical legitimacy of a legal transplant such as freedom of contract will require "a conscious acceptance of the subjects of the law that is preferable" and is taken seriously in practice.¹⁵ For the freedom of contract to function in China in the same way as it has been in the West, the paternalistic features of the law and the institutions must fade away. However, with pervasive state-ownership in the economy and a less than sufficiently free and competitive market, as the prominent Chinese economist Justin Yifu Lin identified, the state will continue to interfere with

⁸ See Wang Liming, *An Inquiry Into Several Difficult Problems in Enacting China's Uniform Contract Law*, 8 PAC. RIM L. & POL'Y J. 351, 357-58 (1999).

⁹ See Jiang & Zhang, *supra* note 5, at 20-25.

¹⁰ See Jiang Ping, *Drafting the Uniform Contract Law in China*, 13 COLUM. J. ASIAN L. 1, 10-11 (1996).

¹¹ RUSSIAN CIVIL AND COMMERCIAL LAW VOLUME 2: LAW OF OBLIGATIONS 35 (William E. Butler ed. & trans., V.P. Mozolin & A.I. Masliaev, eds., 2011).

¹² See Wang, *supra* note 8, at 356.

¹³ See discussion *infra* Section III. B.

¹⁴ See *id.*

¹⁵ See PITMAN B. POTTER, *THE ECONOMIC CONTRACT LAW OF CHINA, LEGITIMATION AND CONTRACT AUTONOMY IN THE PRC* 8 (1992).

the managerial autonomy of Chinese state-owned enterprises (“SOE” or “SOEs”) through both policy burdens and soft budget constraints.¹⁶

According to Lin, the three core issues in Chinese SOE reform are asymmetry of information, incentive incompatibility, and liability disproportionality.¹⁷ These three issues have raised theoretical difficulties faced by Chinese courts in applying freedom of contract. As Lin observes, the problem of asymmetry of information arises because, with a less than competitive market, profit is no longer an effective information indicator by which the Chinese government can evaluate the performance of SOEs.¹⁸ The problem of incentive incompatibility arises because, when SOEs are not operated to maximize the profits, as the state does not possess adequate information of the enterprise performance, SOE managers naturally possess an incentive to further their own personal interest, which is incompatible with furthering the state agenda. The problem of disproportionate liability arises because, without a competitive employment market, SOE managers have little personal stake in the failure of the SOEs; the loss they may suffer is greatly disproportionate to the potential loss of the state. Because the state is unable to hold SOE management accountable for financial failures, it must limit the SOE’s managerial and contractual autonomy to prevent the abuse of that autonomies and opportunism at the expense of the state. The problems with the current contract law theories are that they do not provide courts with theoretical support regarding how freedom of contract should be interpreted differently in China to prevent state’s invasion of contractual autonomy and SOE managers’ abuse of freedom of contract.

In the West, freedom of contract emerged after competitive market had been formed and private ownership was prevalent. Will theories and classic contract law served to protect the competitive environment and restrain the court from interfering with contractual autonomy and free competition. In China, state ownership has been the rule rather than the exception. The SOEs were the only subjects under the ambit of pre-reform contract law and are still pervasive in the contemporary Chinese economy. Moreover, unlike the former Soviet Union and Eastern Europe, the economic reform started by creation of a non-state sector outside the state sector without massive privatization of the latter.¹⁹ Freedom of contract was

¹⁶ See generally JUSTIN YIFU LIN ET AL., CHINESE STATE-OWNED ENTERPRISES REFORM 181 (2001).

¹⁷ See generally *id.*

¹⁸ See *id.*

¹⁹ See Lan Cao, *The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 BROOKLYN J. INT’L L. 97 (1995) (detailing the differences in privatizations between China and Soviet Union).

introduced while ownership had not been transferred to the private sector, and the market was not yet competitive.

Thus, from its inception, the role and function of freedom of contract in such an economy has not always been positive, especially when state-owned enterprises are involved. The state, the controlling or exclusive shareholder of these SOEs, uses a series of institutional networks to supervise the management and monitor the performance of the SOEs to advance state objectives rather than maximizing profits, and to prevent opportunism by SOE managers at the expense of the state. As a result, SOEs carry out goals that are not profit driven; they bear the policy-induced burdens but enjoy a less competitive market environment, soft budget constraints, favorable policy treatments, and subsidies. To understand how freedom of contract or the general theories of contract law work or fail in China compared to the West, it is of paramount importance to appreciate the state's difficult roles as both the referee and a player in a market where competition on a level-playing field does not occur. The two most common problems are: (1) courts, on behalf of the state and in violation of freedom of contract, allow SOEs to renege contracts, which were fair upon conclusion but turned out to be a bad bargain for the SOE, in the name of preservation of state assets and (2) courts, by affording SOE managers the protection of freedom of contract and turning a blind eye to the fairness of the transaction, allow SOE managers to reward themselves by disposing state assets at prices that are tantamount to stripping state assets.

In the first scenario, when SOEs, with the help of the state, are freely allowed to rescind contracts with private parties without committing a breach, both the entrepreneurship and market economy suffer because freedom of contract is not respected.

In the second scenario, these interests suffer because freedom of contract is respected. Even when SOE managers are convicted of corruption, abuse of power, or neglect of duty, they are only punishable in criminal proceedings; the contracts in question are not automatically invalid. The rationale is that the conviction itself does not mean that the contracts reached by these convicted SOE managers were the result of corruption; even if a contract was the result of such criminal activities, it might still be in the interest of the SOE for the contract to be valid in circumstances such as price fluctuation and market changes. If absolute nullity of such contracts were to be assumed, freedom of contract and safety of transactions would be compromised. Therefore, only the aggrieved SOE, along with its new managers and the affected private investors, shall be allowed to request judicial review of the fairness of the contract. If the transaction is determined by the court as asset-stripping, the contract should be declared null and void for its harm to public interest.

Though *laissez-faire* capitalism favors minimum state participation in the market, in reality, the state always has a role in contracting. Across the

globe, at the minimum level, such a role can be seen even in the most typical capitalist countries in government contracts or state monopoly of certain industries to ensure certain public or state interests. The state tends to have a bigger role in civil law jurisdictions such as France, Germany, and Italy than in their common law counterparts such as the U.S. and the U.K. However, it is safe to assume that in the West, outside areas such as defense, energy, and public transportation industries, the markets belong to private parties and are free and competitive in nature.

This article mainly refers to industries where a competitive market exists and it is in the public interest to treat contracting parties equally regardless of the ownership status. On this premise, it is assumed that, in Western law, the state has no role in contracting. On the contrary, the state has such a role in China, given the pervasive presence of SOEs and their dominant share in Chinese economy. A significant part of the Chinese GDP comes from SOEs, and many of the SOEs are not as strictly profit driven. Many efforts have been made to assess the percentage of the Chinese economy owned by SOEs, and the general consensus seems to be that the share would be around 50%,²⁰ even though it is impossible to have an accurate number due to the fact that pure state ownership in enterprises is no longer common. The pervasive presence of state-holding companies and the uncertain number of enterprises and industries under the direct and indirect control and influence of the state make it very difficult to ascertain the real share of state sector in the Chinese economy. Still, certain rough conservative estimates can be made. Among the 120 biggest national state-owned enterprises that are under the authority of State-owned Asset Supervision and Administration Commission (“SASAC”), it has been observed that “as of 2010, total assets of the 120 national SOEs equaled 62% of China’s GDP; total revenues were 42% of GDP.”²¹ Aside from these 120 SOEs under the central government, there are many more SOEs owned by each level of government, many of which are state-holding companies that are controlled by the state ownership. In a 2010 survey, there were 11,405 state holding companies that outnumbered the 9,105 pure SOEs.²² There were also 131 joint ventures where an SOE had ownership interest.²³ In addition, there are township and village owned enterprises

²⁰ See ANDREW SZAMOSSZEGI & COLE KYLE, AN ANALYSIS OF STATE-OWNED ENTERPRISES AND STATE CAPITALISM IN CHINA 1 (2011).

²¹ YINZHI MIAO, OVERSEA LISTING AND STATE-OWNED-ENTERPRISE GOVERNANCE IN CHINA: THE ROLE OF THE STATE 4 (2012), http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2012_Miao.pdf.

²² See SZAMOSSZEGI & KYLE, *supra* note 20, at 8 (quoting National Bureau of Statistics of China).

²³ See *id.*

("TVE") owned by village and township collectives. However, there were only 9,651 companies where state ownership was not specified.²⁴ As a result, the state has a pure financial interest in the outcomes of the contracting by SOEs. Such an interest is not equivalent to public or state interest in the Western law.

When the state has a role in contracting beyond just mere regulator, the state has a conflict of interest that creates competing interests between the government and private investors, which results in difficulties in the protection of private investors. Due to the absence of a market, the state lacks a sufficient information indicator necessary to monitor the performance of SOE managers. The result is the stripping of state assets. Therefore, it is important to limit the role of the state to the extent that it is not detrimental to the economic efficiency or the fairness in contracting. When the role is too invasive, entrepreneurship and productivity in the society are harmed while the lack of state intervention results in the misappropriation of state assets.

Therefore, despite the systematic borrowing of principles from Western contract law including freedom of contract, the same laws and principles may not be easily applied in China. The root problems are those described by Lin, from which this article borrows heavily: incentive incompatibility, information asymmetry, and liability disproportionality.

In China, the market is artificially made less competitive so that SOEs can survive while pursuing non-economic goals imposed by the State. It follows that a fair amount of contracts are made between parties that are not private investors. Nevertheless, the aim of this study is not to urge that Chinese contract law and theories should disregard the wills of the parties. Instead, the goals are (1) to identify what could be validly willed by contracting parties who lack the complete power of disposition over assets; this is to prevent the abuse of freedom of contract by parties that do not bear the negative consequences of such freedom, and (2) to place limitations on the state's interference with contract which, if unrestricted, will eventually destroy freedom of contract.

In the end, despite all the differences in Chinese law and economy, the practice of contract law in China respects philosophical principles and values that Western contract law has honored since Roman law, such as equality in exchange and fairness. This article suggests that courts would not in fact honor the principle of freedom of contract to the same extent as in the West because of the difficulties that would result. The market is not

²⁴ *See id.*

sufficiently free and competitive, and significant ownership rights still belong to the state. We have seen the result in the two scenarios just described. Nevertheless, it is possible to piece together a coherent theory of contract that places substantive fairness in contracting ahead of freedom of contract in circumstances that may result in stripping of state assets or in which an SOE is attempting to shirk a bad bargain. As a result, two types of exploitation emerge. One is the SOE manager's exploitation of state interest while the other is the state's exploitation of private interest. In China, courts must impose extra limits to protect the state's interest from SOE managers and limit the freedom of the state or an SOE to renege a bad bargain with a private party. Both approaches serve to remedy the exploitations in contracting.

The first part of this article will review the history of Western legal thought on freedom of contract. The second part will discuss the pre-reform Chinese contract law that completely denied freedom of contract, its economic logic and its theoretical coherence. The third part will discuss the legal and economic reform along with the introduction of freedom of contract and its theoretical incoherence. The last part will propose a theoretical solution by considering the circumstances in which an expression of will should be held invalid.

II. FREEDOM OF CONTRACT IN THE WEST AND ITS INAPPLICABILITY IN CHINA

A. *The Rise and Fall of Freedom of Contract*

In the history of Western contract law, the battle between the preservation of substantive fairness and freedom of the will of the parties has been ongoing since the rise of 19th century will theory. At that time, freedom of contract gained its dominant role in the major Western jurisdictions such as England, the United States, France, Germany, etc. The universal acceptance of the theory gave rise to heated scholarly debates regarding the roots of the transformation. There are different accounts given to explain what happened to civil law and common law worlds.

It has been said that the rise of will theory in civil law can be traced back to the political thoughts of liberalism and individualism the jurists and code drafters shared.²⁵ In the civil law, substantive justice and fairness of the exchange were respected in the Middle Ages. Relief for *laesio enormis* allowed a contracting party to rescind the contract solely based on an unjust

²⁵ See JAMES GORDLEY, THE PHILOSOPHICAL ORIGINS OF MODERN CONTRACT DOCTRINE 214-215 (1991).

price.²⁶ Late scholastics and the northern natural law school developed the Aristotelian principle of commutative justice.²⁷ In the 19th century, jurists claimed that giving relief presupposed that value is “an intrinsic property of things” when, in fact, it depends on “the mere judgment of men.”²⁸ The remedies for unfair prices were restricted by the Bürgerliches Gesetzbuch (BGB) and *Code Civil* (C.CIV).²⁹

In common law, the wills of the contracting parties and their consent became the central theme of contract law only in the 19th century. From 1770-1870, according to Patrick Atiyah, the role of consensualism rose and that of reliance and restitution damages in contract law declined.³⁰ As a result, the award of expectation damages gained popularity over protection of restitutional and reliance interests.³¹ The cause of this phenomenon has been one of the major debates in the legal history of contract law. According to Morton Horwitz and Patrick Atiyah, the transformation of contract law regarding the breach of executory contracts and the rise of will theory in American law came about to meet the needs of the market economy and *laissez faire* capitalism.³² Alternatively, A.W.B. Simpson argues that the innovation in the 19th century contract law was a borrowing of systematic rules from civil law.³³

However contract law was transformed, the rise of will theories and freedom of contract did encourage free competition and protect the safety and certainty of the transactions. To do so, general theories of contract law had to be blind to details such as subject matter and person.³⁴ One of the principal characteristics of classical contract theory was “the tendency to

²⁶ A contract can be rescinded when a thing was sold for less than half of the just price. A buyer can choose to either pay the difference between the just price and the price paid or rescind the transaction. See James Gordley, *Contract in Pre-Commercial Societies and in Western History*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 2-41 (J.C.B. Mohr, ed. 1997).

²⁷ See *id.* at 2-45-2-49.

²⁸ See Gordley, *Equality in Exchange*, *supra* note 1, at 1592.

²⁹ See *id.* at 1592-93 (noting that nineteenth century German commentary acknowledged that disparity in price itself is not sufficient to invalidate a contract while French commentary went further to deny the existence of just price of things).

³⁰ See generally P. S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 455 (1979).

³¹ See *id.*

³² See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860* (1977); see also ATIYAH, *supra* note 30, at 456.

³³ See generally A.W.B. Simpson, *Innovation in Nineteenth Century Contract Law*, 362 L. Q. REV. 91 (1975); see also A.W.B. Simpson, *The Horwitz Thesis and the History of Contracts*, 46 U. CHI. L. REV. 533, 589 (1979).

³⁴ See Simpson, *The Horwitz Thesis and the History of Contracts*, *supra* note 33, at 400-05.

attribute all the consequences of a contract to the will of those who made it.”³⁵ As a result, “the primary function of the contract came to be seen as purely facultative, and the function of the court was merely to resolve a dispute by working out the implications of what the parties had already chosen to do.”³⁶

The core of freedom of contract is to give binding force to whatever is mutually agreed between the contracting parties.³⁷ Thus, to ensure freedom of bargaining, which was regarded as “the fundamental and indispensable requisite of progress”³⁸ by 19th century economists, courts must not step in to rectify an unfair bargain “since the force of competition will ensure fairness in terms and prices.”³⁹

The autonomy of the free choice of private parties to make their own contracts on their own terms was the central feature of classical contract law. For this contractual autonomy to be truly established and respected, it was required that, under many circumstances, moral justice had to give way to freedom of contract.⁴⁰ Such intellectual and political movement towards liberalism and individualism in the 19th century resulted in the disfavor of the Aristotelian idea of commutative justice.

However, James Gordley presents a different account, arguing that modern contract law is not that different from Roman law and that the substantive justice preserved by Aristotelian tradition is still protected by courts universally to prevent unfair outcomes.⁴¹ In his view, courts across the board in both civil and common law jurisdictions gave relief to one-sided contracts through devices such as *lésion*, usury, and unconscionability.⁴²

Following Aristotelian tradition, Gordley made a strong argument that contracts reached at a price other than the fair market price are all entitled to relief.⁴³ The reasons that remedies given for unfair prices are less often than one would expect are that (1) one is allowed to have the liberty to confer

³⁵ *See id.* at 405.

³⁶ *Id.* at 408.

³⁷ *See generally* CODE CIVIL [C. CIV.] [CIVIL CODE] ART. 1134 (noting that “contracts legally formed have the force of law for the parties who made them.”); *see also* Contract Law of the People’s Republic of China, *supra* note 3 (noting that “parties have the right to lawfully enter into a contract of their own free will in accordance with the law, and no entity or individual may illegally interfere therewith.”).

³⁸ GORDLEY, *supra* note 25, at 214.

³⁹ ATIYAH, *supra* note 30, at 404.

⁴⁰ *See id.* at 422.

⁴¹ *See* Gordley, *Equality in Exchange*, *supra* note 1, at 1656.

⁴² *See generally id.* at 1587.

⁴³ *See generally id.*

benefit to the other party through contracting,⁴⁴ (2) the fair market prices change constantly to reflect the need, cost and scarcity of the goods so the price that seemed unfair after contracting might be fair upon conclusion- a fair bet at price fluctuation is fair,⁴⁵ and (3) it might not be economical for the victim to seek to remedy every unfair price when the damage was small.⁴⁶

The unrestricted role that the rise of capitalism and 19th century liberalism played on the will has undoubtedly declined as Grant Gilmore and Atiyah have observed.⁴⁷ According to them, the destiny of freedom of contract is closely related to that of general theories of contract law, and, in common law, neither of the two existed before the 19th century.⁴⁸ The role of freedom of contract has declined, while the dominant role of the general theory of contract has gradually given way to the protection of consumer interests in transactions where the bargaining powers are extremely unequal, limitations placed on adhesion contracts, the emergence of regulatory law, and sophisticated commercial contracts that will allow parties to opt out of the free bargaining requirements that one would expect from any contract law regime.⁴⁹

Still, in the West, as in most parts of the world, freedom of contract as a doctrine survived these attacks and is widely respected outside the particular limitations mentioned. The resilience of freedom of contract, as a doctrine, comes from the consensus that it is of great value in most societies to allow self-determination in a market economy. Nevertheless, each society finds ways to limit freedom of contract to prevent exploitations of the less informed parties. From Roman law to the contemporary contract law practice, fairness of contract prices always plays a role in deciding whether relief shall be given. The less informed parties may be the shareholders who could not evaluate the contract concluded by the board of directors due to information asymmetry, or a person induced to contract by fraud, duress, or undue influence. In both circumstances, the fairness of prices matters. For example, consider American law governing a fiduciary relation. When the presumption of breach of duty of care is raised, the defendant fiduciary can prove he has met the duty of care by showing the transaction was entirely

⁴⁴ *See id.* at 1652.

⁴⁵ *See id.* at 1613.

⁴⁶ *See id.* at 1654.

⁴⁷ *See generally* GRANT GILMORE, *THE DEATH OF CONTRACT* (1974); *See also* ATIYAH, *supra* note 30.

⁴⁸ *See id.*

⁴⁹ For example, in commercial service contracts, the more sophisticated party often opts out the law in the jurisdiction where the service is rendered through forum selection clause, which was not a result of free bargaining.

fair. Entire fairness includes a fair price and fair dealing. An unfair price alone provides a ground for judicial review; the courts will determine whether the transaction was substantively fair by examining the economic and financial considerations.⁵⁰

B. The Merits of Freedom of Contract and its Incompatibility in China

There are two major views that justify freedom of contract: the moral view and the utilitarian view. However, when neither private ownership nor free and competitive market exists, neither of the two views can justify freedom of contract.

According to the moral view, freedom of contract reflects the progress of society and the social movement from status to contract.⁵¹ People began to “determine themselves and their own life styles by entering into contracts.”⁵² Safeguarding one’s power of self-determination and freedom to act as he chooses became the primary task of a legal system. The idea behind freedom of contract is that “a person in possession of legal capacity, not influenced by mistake or undue pressure, is fully capable of determining his fate as far as legal relationships of private law are concerned.”⁵³

According to the utilitarian view, the society benefits when an arrangement mutually agreed upon is held to be binding. A reasonable person knows his interest better than anyone else, and will only contract when he knows that he will benefit by doing so. Allowing every participant to contract freely allows everyone to benefit, and so allows the society to benefit.⁵⁴

However, neither moral nor utilitarian advantages could have been deemed relevant in the traditional pre-reform Chinese economy.

The moral merits of free contracting could not be relevant. In post-1949 Chinese society individuals were not legally allowed to contract until 1999 and, at the enterprise level, SOE managers entered into contracts on behalf of the state to achieve the state’s objectives rather than their own.

⁵⁰ Thomas A. Uebler, *Reinterpreting Section 141(e) of Delaware's General Corporation Law: Why Interested Directors Should Be "Fully Protected" in Relying on Expert Advice*, 65 BUS. L. 1023, 1028 (2010).

⁵¹ HENRY SUMNER MAINE, *ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS* 165 (1864).

⁵² See KONRAD ZWIGERT & HEIN KOTZ, *INTRODUCTION TO COMPARATIVE LAW* 325 (3rd rev. ed., Tony Weir trans., Clarendon Press, Oxford 1998).

⁵³ BASIL S. MARKENSINIS ET AL., *THE GERMAN LAW OF CONTRACT: A COMPARATIVE TREATISE* 45 (2nd ed. 2006).

⁵⁴ See ZWIGERT & KOTZ, *supra* note 52, at 326.

Furthermore, without a competitive market, a manager was not responsible for the financial consequences arising out the contracts concluded by him on behalf of the state. Moreover, he had no right to determine the contents of contract, when and whether to terminate the contract, or the form of the remedy. As a result, nobody determined his own fate by contracting.

In China, when the managers of SOEs did not share the ownership interest or receive a performance bonus based on the profitability of the SOEs, their personal interest was incompatible with the state's ownership interest. Allowing freedom of contract would have encouraged the managers to engage in opportunistic contracting that benefited themselves rather than the state. Therefore, allowing freedom of contract among Chinese SOEs was inconsistent with the individual autonomy or public interest that freedom of contract promotes.

Contract law certainly predates capitalism and will theories. Principles such as equality in exchange, commutative justice, and fairness guided contractual transactions in pre-commercial societies and post commercial but pre-capitalist civil law.⁵⁵ In view of the difficulties mentioned earlier, one must ask whether every industrialized society must have contract theories that are based solely on the will and autonomy. Does the principle of freedom of contract apply to any human society regardless of the particular features in its economy, or are there certain prerequisites for this doctrine to be justifiable?

Admittedly, it has been pointed out that the history of freedom of contract is also the history of its limitations.⁵⁶ Also, it is true that freedom of contract has become an unattainable ideal in Western society just as it is in societies such as China where private ownership and competitive markets are absent. One might doubt the value and utility of comparative law scholarship made that compares the freedom of contract in Western societies and China when freedom of contract has become an unobtainable ideal in virtually all societies and, as in the West, China has declared its compliance with international standards by making freedom of contract a fundamental principle in its contract law statute.

Nevertheless, this situation is not a distinction without a difference. At least, the causes of difficulties in applying freedom of contract as a doctrine are different. Chinese and Western law may seem to converge as central economic planning no longer serves as the only means in the allocation of

⁵⁵ See generally Gordley, *supra* note 26, at 2-23, 2-24.

⁵⁶ 韩世远[HAN SHIYUAN] 合同法总论[GENERAL THEORIES OF CONTRACT LAW] 38-39 法律出版社 (Law Press 2011).

commodities in China, and *laissez-faire* capitalism has lost its charm in the West. Still, the fact that the autonomous rights in contracting among Chinese SOEs are still limited compared to the Western counterparts creates a distinction.

In the West, freedom of contract served to boost the free and competitive market economy. As a result, big corporations arose which destroyed the freedom of bargaining. Paternalistic government interventions became necessary to remedy the extremely unequal bargaining power. Their goal was to restore freedom of contract and free bargaining to best possible extent. As an ideal, freedom of contract is still desirable in the West. Paternalistic measures are put in place to annul standard form clauses, and to reconstruct the terms the weaker party would have agreed to.

In China, freedom of contract was not and is not desirable given the endogenous features of Chinese SOEs. When examining the economic history of the birth of freedom of contract, one can see the social and economic conditions during the industrial revolution that warranted the emergence of freedom of contract. They include private ownership of business, free and competitive markets, individualism, and the triumph of the will theories. These conditions did not exist before the Chinese economic reform and are still limited by the paternalistic features of Chinese economy three decades afterwards. As a result, the adoption of freedom of contract does not bring about the same desirable effects as it had produced in the West. Instead, in China, freedom of contract will intensify the moral dilemmas Western courts have faced. Consequently, differences in contract law can be justified for good reasons and will not be eliminated without massive privatization and introduction of a free and competitive market in the Chinese economy. To understand such differences, one has to start with the economic logic that justified the trinity of Chinese traditional economy: centralized allocation of resources, price distortion and micromanagement of the SOEs.⁵⁷

III. THE LOGICAL STARTING POINT: THE DENIAL OF THE PRIVATE ECONOMY

A. *The Economic Logic in the Establishment of SOEs*

Upon the founding of the communist regime in 1949, the government realized the development of heavy industry as a priority in national economy for China if it were to survive the economic embargo and military

⁵⁷ See JUSTIN YIFU LIN ET AL., *THE CHINA MIRACLE: DEVELOPMENT STRATEGY AND ECONOMIC REFORM* 59 (Rev. Ed., The Chinese University Press, 2003).

threats imposed by the West.⁵⁸ With a backward agrarian economic structure and a labor-abundant but capital-scarce economy, it was essential to be able to channel the limited capital available into heavy industry while suppressing the prices of products and other factors indispensable for the heavy industry, such as raw materials, labor, services, energy, and agricultural products.⁵⁹ Also, industrial residues from other industries needed to be maximally channeled into the heavy industry.⁶⁰ Because private investors would have more incentive to invest in the service industries where abundant labor can be used at bargain prices, it was economically logical for the government to nationalize heavy industry and establish state-owned enterprises to carry out state objectives regardless of financial profitability. Sectors outside the heavy industry were nationalized to lower the cost of resources needed for heavy industry. Such resources were channeled into heavy industry at below market prices. Such an allocation of resources would not have prevailed if these sectors were in the hands of private investors.⁶¹

It logically follows that, after the thorough nationalization, private sector was eliminated and the state owned every single business. Only legal persons (state-owned enterprises, government agencies, and village collectives) were allowed to contract.⁶² The free market was replaced by a pure supply system. When there was no market, and the sole purpose of industrial production was to carry out state economic plans, there was a natural incompatibility in the incentives to serve state objectives and those of the SOEs. In a competitive market, profitability is the most effective information indicator for managerial performance. It is a checks and balances mechanism that holds managers accountable for their performance. When a market does not exist, the owner of the SOEs, the state, has no equally effective indicator to evaluate the performance of SOE managers. Without a market, profit and loss no longer reflect managerial performance.

⁵⁸ See LIN, *supra* note 16, at 21.

⁵⁹ See *id.* at 20-28.

⁶⁰ See *id.*

⁶¹ Heavy industry itself is capital-intensive and the price to use limited capital in a poor country like China was extremely high. The threshold would have been much lower and the investment much more profitable to invest in light industry rather than heavy industry. In 1957, profit and tax generated by the same capital in light industry was 270 percent than that in heavy industry. If a free and competitive market was available for private investors, there would have been a much lower incentive for the investors to channel their capital into the heavy industry. In addition, if resources were allocated through a free market, it would have been too expensive to realize the rapid growth when the prices of capital and raw materials, labor and energy were at their fair market prices. See *id.* at 21-22.

⁶² See 关于工矿产品订货合同基本条款的暂行规定[The Tentative Rules on Industrial and Mining Products Ordering Contract] art. 3 (1963) (China).

In an economy with such serious price distortion as that of pre-reform China, price did not reflect the scarcity of resources. The profit level could be heavily influenced by state economic policies. Since it was unlikely to hold SOE managers financially accountable, when managerial or contractual autonomy was allowed, SOE managers tended to reward themselves by retaining more profits and raising wages, which conflicted with the state agenda that called for rapid development of the heavy industry at the lowest cost. In addition, the personal stakes SOE managers as career bureaucrats had in the operation of SOEs were disproportionate to the potential losses state might suffer from opportunistic deviation from state plans.

In the West, it is the incentive divergence rather than incentive incompatibility that corporate law theories work to reduce. The premise of the theory is that when one person exercises authority that affects another's wealth, interests may diverge. Business managers, as the agents of the investors, always have divergent interests from the investors. Such a divergence exists in any agency relation.⁶³ The smaller the share of ownership that the managers hold, the larger the divergence of interest becomes. For example, the manager will not have the same level of incentive to make an extra effort to increase the profit of the enterprises as the investors themselves would have if their own share of ownership is small and the increase of their own wealth is small compared to their extra efforts.⁶⁴

In the Western free market and free enterprises system, such a divergence can be controlled in three ways:

- 1) There is the employment market: an unfaithful or indolent manager may be penalized by a lower salary, and a diligent one rewarded by a bonus for good performance. This is function of incentive-compatible contracts- that rewards managers for good performance and penalize them for bad. The goal is to align the interests between managers and shareholders as closely as possible.

- 2) The threat of sales of corporate control induces managers to perform well in order to keep their positions.

⁶³ FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 91 (Harvard 1991).

⁶⁴ *See id.*

3) Competition in product markets helps to control agents' conduct, because a poorly managed firm cannot survive in competition with a well-managed firm.⁶⁵

However, these mechanisms reduce but cannot eliminate the divergence of incentives. Consequently, principles of fiduciary duty are used to avoid direct and extensive monitoring and elaborate internal contracting that would allow the investors to evaluate the managerial performance. Managers are allowed to exercise managerial discretion, but will be held accountable for the negative managerial conduct that violates the requirements of fiduciary duty. Therefore, the business judgment rule controls. The rationale behind this rule is the recognition that investors' wealth would be lower if manager's decisions were routinely subjected to strict judicial review.⁶⁶

In China, before the economic reform, SOE managers, if given the managerial and contractual autonomy permitted by the American business judgment rule, would have tended to maximize the profits of the enterprises or avail themselves of the industrial surplus, neither of which was consistent with the state's objective to prioritize the heavy industry. Therefore, the purpose of SOEs for the state, as the sole investor in SOEs, was to implement its economic plans rather than to use the SOEs to maximize its wealth. SOE managers were instructed to adhere strictly to economic directives and orders. Logically, it made sense that SOE managers should not be accountable for the profitability of the SOE. As a matter of fact, SOEs' business operations often resulted in heavy deficits. When the profit-motive was not permissible, managers tended to intercept the industrial residual and to misappropriate state assets, if any managerial autonomy was afforded to them. Such an incompatibility could not be cured by negotiating incentive-compatible contracts between state and SOE managers through the employment market simply because managers had no ownership interest in SOEs. The direct result was that the incentives between the two were opposed. Again, there were no employment markets for corporate executives since all the managers were government employees at the same time. Also, SOE managers could be laterally transferred to other government positions. Finally, a poorly managed firm could still survive when there was no market available to push it out.

As contractual and managerial autonomy could not be justified, it was necessary for the state to supervise every aspect of the business operation to make sure the state economic plans and objectives received priority over the

⁶⁵ *See id.*

⁶⁶ *See id.*

individual agenda of an enterprise itself. Before the economic reform, at the enterprise level, SOEs did not have production decision-making autonomy.⁶⁷ SOEs could not decide what to produce, their research and development direction, or how much they were going to produce.⁶⁸ In order to negate the incentive for profit maximization, SOEs did not have independent budgets and would not be held accountable for deficits. All the deficits had to be absorbed by the state and virtually all the profits were turned over to the state as well.⁶⁹ For the same reasons, SOEs could not set employee wages on their own. Moreover, autonomy in resource allocation was taken away from SOEs. When allocation of resources was not completed through the market and prices of the raw materials were artificially suppressed, prices no longer reflected the scarcity of the resources. If SOEs were allowed autonomy to decide what resources they needed and how much was needed, every SOE would have the incentive to acquire more resources at suppressed prices by increasing the cost of production.⁷⁰ As a result, each enterprise would submit a proposal to the material supply agency within the government describing the resources and materials needed to complete the mandatory plans assigned by the state. The government would deliver the materials, once the proposal was approved, based on the state economic plans.⁷¹ The SOEs did not have the autonomy to select suppliers or compare the products.⁷²

Consequently, instead of the decentralization of business decision making in the West, in the pre-reform Chinese economy, the state had to give specific directives to individual enterprises on the types of products to be manufactured, the quantity, quality, and specifications of the products, the kind and quantity of the raw materials an enterprise received, the pricing and the buyer of the products, and the wages of labor and management. Any unauthorized reselling of products and sale of unauthorized products would result in the nullity of a contract, along with civil and criminal sanctions. Contract management was strictly carried out by various ministries, departments and economic commissions at all levels of the government.

B. The Theoretical Coherence of Socialist Contract Law

Intellectual efforts had been made by socialist jurists to piece together coherent contract theories that would support the planned economy.

⁶⁷ LIN, *supra* note 16, at 32.

⁶⁸ *See id.*

⁶⁹ *See id.* at 33.

⁷⁰ *See id.*

⁷¹ *See id.* at 37-38.

⁷² *See id.* at 38.

According to the theorists, ownership of the means of production was exclusively in the hands of the state.⁷³ Even means of subsistence, the resources necessary for people's daily consumption, could not be traded on the market.⁷⁴ The only interest protected in contracting was the state's interest. The institution of contracts served as an important tool in ensuring the implementation of state plans.⁷⁵ Contracting connects the enterprises systematically and helps to clarify and determine the content of state plans.⁷⁶ Since no private interest is involved, all the contracting parties were simply executing orders from the state. Therefore, the contracting parties were to collaborate and supervise each other throughout the performance of contract to carry out the state's agenda.⁷⁷ A party who defaulted was liable for penalties and damages. Any deviations from the plan would result in the illegality of the contract. The only overlap between the state and private sector lay only in the uniformed procurement and supply where prices were set by the state.⁷⁸

The 1958 *Civil Law textbook* ("the Treatise"), presented a coherent socialist contract theory. In the Treatise, even though freedom of contract was criticized for its lack of legality, contractual autonomy was not entirely denied.⁷⁹ The Treatise proposed that the principle of voluntariness and reasonableness be the fundamental principle of contract law.⁸⁰ However, the Treatise stressed that contracts should be entered for the sole purpose of implementing state plans and where state and individual interests coincided.⁸¹ According to the Treatise,

⁷³ The leading treatise at the time, known as the 1958 Civil Law Textbook, pronounced that the elimination of capitalist ownership was completed through public private joint venture and the petit private ownership of peasants and craftsmen were gradually eased out through their "voluntary participation in the rural cooperatives." As a result, private ownership of means of production had ceased to exist. See 中央政法干部学校民法教研室 [Teaching and Research Section of the Central Political and Legal Cadres' School, ed.] 中华人民共和国民法基本问题[BASIC ISSUES OF CHINESE CIVIL LAW] [hereinafter, *The Treatise*] 26 (Beijing: Law Press, 1958).

⁷⁴ The rationale was that private means of subsistence was protected but could not in any way abuse means of subsistence to harm public interest or exploit others. See *id.* at 129.

⁷⁵ *Id.* at 26.

⁷⁶ *Id.* at 27.

⁷⁷ See discussion *infra* Section IV.B.

⁷⁸ 梁慧星 论我国合同法律制度的计划原则与合同自由原则 《法学研究》1982年第4期 第44页 [Liang Huixing *On the Plan Principle and Principle of Freedom of Contract in Our Contracting System*, Legal Studies Vol. 4, 44 (1982)].

⁷⁹ See generally *The Treatise supra* note 73.

⁸⁰ See *id.* at 202.

⁸¹ *Id.*

[c]ontracting should follow parties' voluntariness and its conclusion must be based upon the free declaration of wills, sufficient mutual negotiations, and the meeting of minds. Neither party is allowed to impose its will on the other by ordering the other party to accept its opinion or other illegal means through the conclusion of contract.⁸²

Furthermore, reasonableness requires that

the content of a contract must be fair and reasonable so that neither party's interest is harmed, neither could the contract harm public and social interest. The whole or part of a contract shall be annulled if the content of the contract was obviously unfair or unreasonable.⁸³

The content of these two requirements resembles the Western view of freedom of contract and its limitations. Classical contract theory gave wills of the contracting parties binding force barring illegality and immorality or violation of public policies.⁸⁴ It was also not unusual for devices such as *Wucher* in German law, *lésion* in French law, and unconscionability in common law to cure unfair prices. It was said in China that prices of commodities in the West were determined by Marx's law of value, which guided the circulation and production activities in the society.⁸⁵ However, in the view of the Treatise, the unavoidable phenomenon of price fluctuation in the West was used as a means by capitalists, the only class that owned means of production, to exploit toilers by engaging in opportunistic behaviors. China, on the contrary, by establishing the socialist economy, limited the effectiveness of the law of value.⁸⁶ Through careful planning, the state supposedly would be able to set the prices of commodities differently from its values. Such differences were being used consciously to "adjust the circulation of commodities" with the purpose of "improving the quality of toilers' material and cultural lives."⁸⁷

However, the Treatise argued that the difference between principles of voluntariness and freedom of contract lies in that freedom of contract emphasized voluntariness while neglecting the requirement of legality.⁸⁸ The voluntariness principle, according to the Treatise, allows contracting parties to freely express their wills provided but only within the scope

⁸² *Id.* at 203.

⁸³ *Id.*

⁸⁴ See ZWEIGERT & KOTZ, *supra* note 52, at 381.

⁸⁵ See *The Treatise*, *supra* note 73, at 217.

⁸⁶ See *id.*

⁸⁷ See *id.*

⁸⁸ See *id.* at 204.

permitted by law.⁸⁹ For example, in a sales contract, elements such as the object and the range of the prices must be prescribed by law.⁹⁰ Capitalist law was criticized as permitting unlimited autonomy in contracting, which allowed the owners of means of production unlimited exploitation of the toilers.⁹¹ Allowing free contracting without setting the variety and price of commodities would result in monopoly, at which point, contract terms would no longer be negotiated.⁹² Toilers then only have the options of accepting the terms or refusing to contract. This meant allowing exploiters the freedom of exploitation without letting the toilers have the freedom not to be exploited.⁹³ Therefore, only in the communist regime, would toilers be free from exploitation. According to Mao Zedong, when bourgeois class had its freedom, there would not be freedom for proletariats.⁹⁴ The Treatise concluded that principle of voluntariness is a unification of freedom and discipline where “proletarians enjoy a wide range of freedom but restrain themselves through socialist discipline.”⁹⁵

Transactions between individuals in the shadow economy were deemed illegal but could not be regulated otherwise since law does not allow transactions between private parties. Outside the shadow economy, the only transactional relationships between the state and private parties were the procurement of products from the state and supplies of commodities to the individuals. In such circumstances, no competition between the state and private interests existed and the state did not have to play contradictory roles as a referee and a player at the same time, the roles it now plays in the post-reform economy. The issues with the state invasion of private interest by allowing SOEs to back out of a bad bargain with a private party did not exist. Also without private ownership and a market, courts would not have to face the theoretical difficulties as to whether to observe the external formalism as freedom of contract would require and restrain themselves from reviewing the substance of the contract. Courts would always be able to annul a contract where a state interest of any sort was jeopardized.

⁸⁹ *See id.*

⁹⁰ *See id.*

⁹¹ *See The Treatise, supra* note 73, at 204.

⁹² *See id.* at 204-205.

⁹³ *See id.* at 205.

⁹⁴ 毛泽东 [Mao Zedong] 《关于正确处理人民内部矛盾问题》 [On How to Handle the Internal Conflicts among the Masses] (1937).

⁹⁵ *The Treatise, supra* note 73, at 206.

Therefore, theoretical coherence of socialist contract law was achieved regardless of its limited practical application.⁹⁶

IV. THE RISE OF FREEDOM OF CONTRACT IN CHINA AND ITS LIMITATIONS

A. *The First Round of the Economic Reform*

Given the poor efficiency and the shortages caused by the pre-reform economic structure, the Communist Party leadership reached a consensus that this structure was not sustainable. In contrast to the later reforms in the socialist regimes in Central and Eastern Europe, China reformed its SOE sector without privatizing it and allowed a private sector to emerge outside the state sector.

Since the beginning of the economic reform at the end of 1970s, efforts had been made to cure the inefficiency and insensitivity of the State-run economy. More autonomy and incentives were given to the State-owned enterprises while at the same time, a private sector opened up to legalize the existence of non-SOEs. Rural peasant households and urban individual business households were prime examples of the emergence and growth of the private ownership. Private enterprises, Township Village Enterprises, and foreign invested enterprises (“FIEs”) grew at remarkable rate. The share of SOEs in industrial output fell from over 80% to below 60% in 1988, and to below 30% in 1997.⁹⁷ In 2002, less than 15% of the enterprises were SOEs. At the beginning, SOEs were allowed to retain certain percentage of profits above the quota, which created the incentive to make profits. Later, SOEs were allowed to negotiate detailed performance contracts with the government that allowed operational and contractual autonomy in enterprises.⁹⁸ Moreover, SOE employees no longer had tenure employment and their performance was linked with the performance.⁹⁹ The economic reform, with continued dominant state ownership in business to pursue non-business driven goals and the absence of a free and competitive market, improved management efficiency, but created the theoretical incoherence. This is because the changes do not cure the pre-existing problems of incentive incompatibility, information asymmetry, and liability disproportionality, which were the very reasons for the denial of contractual autonomy and incentive to maximize profits. SOEs continue to operate

⁹⁶ The Socialist contract theory does not have practical application to shadow economy or any contractual transactions that do not involve state or state-owned enterprises.

⁹⁷ See SHAHID YUSUF ET AL., UNDER NEW OWNERSHIP: PRIVATIZING CHINA’S STATE-OWNED ENTERPRISES 60 (2006).

⁹⁸ See *id.* at 59; see also LIN, *supra* note 16, at 54-56.

⁹⁹ See YUSUF, *supra* note 97, at 56.

based on goals that are not business driven, resulting in practices such as overstaffing to reduce urban unemployment rates, or selling essential products at prices well below fair market value.

When managers are not accountable for their financial performance due to the absence of a reliable indicator by which performance can be evaluated, allowing SOE managers the same level of contractual autonomy that freedom of contract will permit them will not produce the same utilitarian effects as in the West. They are not bearing the negative consequences of their decisions, and the incompatibility of the incentives that motivate them cannot be reduced or controlled by the fiduciary duty principles.

Over a decade after the SOE reform, the results were conflicting and improvement in efficiency stalled. In 1995, 44% of SOEs were operating in deficit.¹⁰⁰ Legal reform took place to adapt to the new economic conditions. The Economic Contract Law (“ECL”) was enacted in 1981 to recognize the rights and interests of contracting parties. The parties’ wills were respected when they did not conflict with laws, public policies and state economic plans. Still, contracts were closely monitored by the state to prevent entrepreneurial opportunism because when the law was enacted virtually all contracting parties were SOEs. The forms that a contract must take and the terms that must be included are stipulated in the Economic Contract Law. Also, the violation of state economic plans results in the nullity of a contract. Moreover, such a contract was deemed void, not voidable, and so the contracting parties did not have the option of choosing not to avoid it. Safeguards to ensure transactional safety in the West, such as the doctrines of apparent authority and *ultra vires*, were deemed illegal mainly to prevent SOE managers’ opportunistic attempt to maximize the profits.

As cases decided in this period will show, any autonomous business conduct such as the purchase of unauthorized products, the resale of purchased products at a higher price, or the sale of products to unauthorized purchasers would result in the nullity of the contract and civil and economic sanctions. No matter how ridiculous these decisions might appear in the eyes of Western lawyers, illegality and violation of public policy are universally recognized as grounds on which a contract is void. Moreover, because virtually all business entities allowed to contract at that time that the ECL was enacted were owned by the state, no private interest could have been harmed by nullifying all contracts. At the beginning of the economic reform, private parties were simply not within the purview of the ECL.

¹⁰⁰ See LIN, *supra* note 16, at 66.

B. *The Guiding Cases*

In the 1980s, several collections of economic contract cases were published by government authorities and served as guidance for courts at all levels in deciding economic contract cases. The description in this study of how the ECL was interpreted in the 1980s is based on an analysis of 50 cases included in one of these collections entitled *An Analysis of Economic Contract Cases*.¹⁰¹ These cases were decided between 1979 and 1986. Virtually all contracting parties in the collection were SOEs, with the exception of individual business households.

China has always followed the civil law tradition, which officially denies that cases have the authority of *stare decisis*. Unofficially, however, these cases played a significant role in forming a coherent practice in contract law nationwide. Courts do consult guiding cases from the case collections and the gazettes of the people's courts in making decisions, even though there was no uniform case reporting system, and courts have never been allowed to cite cases. The absence of a civil code made these cases even more influential as judges did not have a legal source more authoritative than the collections. In addition, the case collections also provided official comments that either explained the rationale behind the court decisions or pointed out the mistakes the courts made in interpreting the law.

As we have seen, more managerial and contractual autonomy was given to SOE managers. However, when a competitive market and private ownership rights in SOEs were still lacking, one of the main problems the post-reform system had to deal with was preventing SOE managers' opportunistic behavior to encroach upon state interest or to strip state assets through self-dealing. A large proportion of the cases had to deal with illegal profiteering by SOEs through resale, *ultra vires* activities outside their scope of businesses, or the apparent authority of an agent who tried to bind the SOEs. This was why the Western doctrines of *ultra vires* and apparent authority were not recognized in China. As we have seen, profiting by resale was illegal and could be penalized.

On the other hand, courts in several cases emphasized the binding force of a contract voluntarily entered into, which changed the pre-reform

¹⁰¹ See WANG ZONGHUA & YIN HONGFENG (王宗华 殷红峰), JINGJI HETONG JIUFEN ANLI XUĀNBĀN (经济合同纠纷案例选编)[Selected Cases on Economic Contract Disputes] (1987) [hereinafter "The Collection"]; see also Roderick W. MacNeil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 307 (1986). It was said that the collections on economic contract cases were the very first collections of cases in any field in Chinese law.

paradigm where parties did not care whether a contract was enforced, and the performance of a contractual obligation depended on the ability of the obligor and the relationship between the managers of the two contracting enterprises.¹⁰²

Also, courts were entrusted with minimizing the harmful effects of contracting to the collective system. As a result, courts decided the cases based on the principles of loss splitting between the parties and reciprocal accommodation of each other's difficulties.

i. Who May Contract

Courts made it very clear that only legal persons were allowed to enter a contract, and the only entities that qualified as legal persons were SOEs. In a 1986 case, the court declared a sales contract of 5,000 color TVs at RMB 1,500 yuan per TV null and void when the defendant-seller defaulted and the plaintiff-buyer brought the suit to enforce the contract.¹⁰³ The contract was entered by the industrial company affiliated with the municipal bureau No. 1 and the materials supply station of the municipal bureau No. 2. The main reason for annulment was that neither party was considered a legal person and therefore neither was allowed to enter into economic contracts. The reason was probably because the affiliations of these two companies made them a branch office of government agencies and so deprived them of the independent status as legal persons. In addition, since neither apparent authority nor agency by estoppel was recognized in China at that time, it was impossible to bind the superior government agencies with which they were affiliated. In addition, selling color TVs was outside their scope of business. The second ground for annulment was profiting through resale.¹⁰⁴ According to the investigation conducted by the court, these Toshiba Color TVs came originally from state foreign trade agencies, who sold the TVs at RMB 1,200 yuan to the supplier, a government designated retailer.¹⁰⁵ The supplier should have been selling the TVs to the general public rather than reselling the TVs.¹⁰⁶ However, the supplier sold the TVs to a department store at RMB 1,300 yuan per set. After a few rounds of reselling, this contract was concluded at the price of RMB 1,500 yuan. According to the court, such opportunistic buying and reselling was illegal. Not only was the contract annulled, both parties were fined. In

¹⁰² See POTTER, *supra* note 15, at 28.

¹⁰³ The Collection, *supra* note 101, at 3.

¹⁰⁴ See *id.*

¹⁰⁵ See *id.*

¹⁰⁶ See *id.*

addition, the illegal gains obtained by every entity on the supply chain were confiscated.¹⁰⁷

In another case, a contract was deemed absolutely null when one of the contracting parties was not a legal person. The contract in dispute was over an earthwork construction contract between a general contractor, the No. 1 Municipal Construction Company of City A, and a subcontractor, the No. 2 County Construction Company of Province B.¹⁰⁸ The general contractor won the bid for an earthwork construction project and assigned the No. 5 construction brigade under it to undertake the project.¹⁰⁹ However, the brigade subcontracted the entire project to the subcontractor at a rate lower than the budget quota issued by the municipal Construction Committee.¹¹⁰ The subcontractor soon found out that the price offered was not sufficient to finish the project so it asked to rescind the contract, and the general contractor agreed.¹¹¹ The general contractor later sued the subcontractor attempting to have the contract enforced.¹¹² Surprisingly, the court did not annul the contract on the grounds that the subcontract was illegal but only held that the No. 5 brigade, as a non-legal person, was not qualified to enter into an economic contract.¹¹³ Therefore, not only was the contract null, but the plaintiff had to bear all the damages and court costs.¹¹⁴

Though more information is needed to fully appreciate the court's decision, it may be suspected that the contract was concluded under the seal of the brigade rather than that of the construction company. Therefore, the contract was annulled for the want of the official seal of a legal person. Only the construction company qualified as a legal person, not the brigade under it. It was clear that the contract was agreed upon between the two construction companies who were both considered legal persons. The court used this technicality to annul the contract rather than rely on the ground of violation of the pricing regulation. According to the official comment, the plaintiff's subcontracting activity should be condemned.¹¹⁵ Again, we see opportunistic behavior of SOEs in maximizing their profits. Such conduct would not be common in the pre-reform regime when SOEs had to turn over all of the profits and state would absorb all the deficits. In 1992, a departmental rule issued by the Ministry of Construction officially outlawed

¹⁰⁷ *See id.* at 4.

¹⁰⁸ *See id.* at 5.

¹⁰⁹ The Collection, *supra* note 101, at 5.

¹¹⁰ *See id.*

¹¹¹ *See id.* at 6.

¹¹² *See id.*

¹¹³ *See id.*

¹¹⁴ *See id.* at 7.

¹¹⁵ The Collection, *supra* note 101, at 7.

such subcontracting where the general contractor assigned the entire contract to a subcontractor without assuming any supervisory responsibilities but charged a management fee.¹¹⁶

As an exception to the legal person requirement, courts have held that individual business households and members of rural agriculture communes could enter into economic contracts with legal persons.¹¹⁷ This exception was also recognized in the miscellaneous provisions of the ECL.¹¹⁸ The official comment in the collection explained that “individual business households refer to individually-run businesses in the industries of handicraft, retail, dining and service etc. Such individual businesses were supplement to the socialist public economy. Their lawful interests are protected by the state law.”¹¹⁹

ii. Strict Prohibitions Against Ultra Vires and Apparent Authority

As we have seen, when prices were not liberated and a competitive market did not exist, many kinds of opportunistic conduct were pursued. SOE managers attempted to reward themselves by taking advantage of the difference in pricing between state plans and the market, by trading the resources they were authorized to buy and sell with the resources they were not authorized to, or by encroaching on state interest whenever they acquire any autonomous rights. Therefore, any expansion of the designated autonomous rights or delegation of any authority is prohibited from harming the collective system. As we will see, courts denied both *ultra vires* activities and the ECL itself prohibited the exercise of apparent authority and annulled the contracts entered outside the scope of agency.

a. The Denial of Apparent Authority

In a 1984 case, a hospital refused to accept several shipments of medical instruments delivered to them and to pay for them according to four

¹¹⁶ 工程总承包企业资质管理暂行规定 [Provisional Rules on the Qualifications of Construction General Contractor Enterprises](promulgated by the Ministry of Construction, effective 1992), Act No. 189/1992 (China).

¹¹⁷ See The Collection, *supra* note 101, at 78.

¹¹⁸ See 中华人民共和国合同法 [Economic Contract Law of the People's Republic of China](promulgated by the National People's Congress, Dec. 13, 1981, effective July 1, 1982) 1981 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ 12 (amended 1997), Art. 54 [hereinafter Economic Contract Law].

¹¹⁹ The Collection, *supra* note 101, at 79.

sales contracts they appeared to have entered into with the manufacturer.¹²⁰ Again, both parties were state-owned enterprises. According to the court's investigation, it turned out that four contracts were executed by a hospital staff member posing as an agent of the hospital. He entered contracts on behalf of the hospital and his identity was verified by the seal of the hospital general affairs office that he carried with him and used to contract.¹²¹ Two of these contracts were affirmed by the hospital while the other two were entered without the leadership and a legal representative of the hospital knowing.¹²² The manufacturer had no reason to know that the staff member of the hospital did not have the authority to conclude the latter two contracts. The court affirmed the validity of the first two contracts, but held that the two later contracts were void because they were not entered by the legal representative of the hospital, and the seal used was not the hospital seal, which was the only valid seal for contracting purposes.¹²³ The official comment criticized the hospital for its mismanagement in entering into the void contracts while also criticizing the plaintiff was also at fault for not verifying the agent's identity.¹²⁴ For that reason, the court costs were borne by both parties.¹²⁵ The comment claimed that the unauthorized agent alone should bear all the damages. Since the collective economic system would be at loss if the products manufactured were not wanted, as a result, under the court's mediation, the hospital was willing to pay for the two valid contracts in full and 90% of the contract price of the two invalid contracts.¹²⁶ The comment admitted that according to the ECL when a contract is annulled, property received through contract should be returned. Nevertheless, the court-supervised mediation was commended because the court recognized that the medical instruments in dispute were needed by the hospital anyway and so it encouraged the parties to reach a new sales contract.¹²⁷ The behind-the-scenes rationale of the decision was to minimize the loss of the state. This is because the only party who suffered the loss would be the state if the manufactured goods were not needed. The principle is that such loss suffered by the state should be minimized and shared by SOEs.

In a 1982 case that occurred just before the ECL took effect, a merchandiser of a Beijing chemical plant fertilizer (the buyer) was sent to purchase conductive tapes from a Hebei province manufacturer.¹²⁸ The

¹²⁰ *See id.* at 10.

¹²¹ *See id.*

¹²² *See id.*

¹²³ *See id.*

¹²⁴ *See id.* at 12.

¹²⁵ The Collection, *supra* note 101, at 12.

¹²⁶ *See id.*

¹²⁷ *See id.*

¹²⁸ *See id.*

sourcing agent was not aware of the specifications of the tapes the principal asked for when he made the order, and therefore ordered the wrong type of tapes.¹²⁹ The contract terms were based on mutual consultations.¹³⁰ However, when the manufacturer was manufacturing the tapes they were not sure about the length of the diameter for the end.¹³¹ The contract said the length should be 8mm.¹³² The manufacturer was not sure whether it should be 8mm on one end or both ends and took the liberty of manufacturing tapes with 8mm in length on one end and 22mm on the other.¹³³ When the parts were delivered to the buyer in Beijing, the buyer did not inspect them upon receipt.¹³⁴ When it was later discovered that the tapes could not be used, the buyer refused to pay.¹³⁵ After several failed attempts made by the supervisory government agency to mediate, the manufacturer sued and requested the court to enforce the contract. Lacking a statutory authority such as the ECL, the court did not address the validity of contract directly. The court attributed the responsibilities of the waste of the tapes mainly to the sourcing agent, “a lay person who made the order without fully understanding the business.”¹³⁶ The manufacturer was partially responsible because “they rushed into the project without making sure the specifications and types of the parts, and took the liberty in enlarging the diameters.”¹³⁷ The solution was again reached through court-supervised mediation. As a result, the buyer agreed to return all the tapes and compensated the manufacturer 25% of the contract price.¹³⁸

To Western lawyers, distinct features of Chinese contract law practice are apparent. First, the defendant who should have been bound by the contract concluded by its agent was not legally liable for the breach of contract whilst the defendant still was asked to pay a fraction of the contract price without accepting any parts. As we can see, the courts tended to make SOEs liable for their own negligence in their management’s decision making and contracting. SOEs were not necessarily liable to the other party but to the state, which bore the economic consequence of bad contracting.

The court’s decision in this case was both commended and criticized by the comment. The comment commended the decision in that “the court

¹²⁹ *See id.* at 13.

¹³⁰ *See id.*

¹³¹ The Collection, *supra* note 101, at 13.

¹³² *See id.*

¹³³ *See id.*

¹³⁴ *See id.*

¹³⁵ *See id.*

¹³⁶ *Id.*

¹³⁷ The Collection, *supra* note 101, at 13.

¹³⁸ *See id.*

attributed the liabilities between the parties properly, protected state economic interest and reduced the economic loss for both parties. Such a decision promoted the stability and harmony in the society and the development of socialist modernization.”¹³⁹ The comment further explained that if it were decided under the ECL, the court should have found both parties liable. Article 12 of the ECL requires that the major contract terms be clear and specific. Here, the buyer in its telegraph to the manufacturer did not specify the type and specifications of the parts and sent a merchandiser who was not familiar with the technical details of the parts to make the order.¹⁴⁰ The manufacturer was also liable in performing the contract.¹⁴¹ When in doubt about the diameter of the tapes, they did not ask the buyer for clarification but rather took the liberty to enlarge the diameter. Thus they should be liable for the consequence.¹⁴²

Consistent with this comment, with the enactment of the ECL, the principal became liable for damages caused by the contract entered by an agent exceeding his scope of agency even though contract itself was still deemed null and void.

In a 1984 case where an electrical machinery company concluded a contract with a trading firm to purchase three cars when the signing agent was only asked by the principal, the company, to purchase electrical machinery parts.¹⁴³ The agent sensed the profitability of this car purchase and asked the legal representative, the only agent with appropriate authority to bind the company, to confirm the contract but was rejected.¹⁴⁴ The court annulled the contract citing article 16 of the ECL to determine the form of remedy. Article 16 permitted return of property and restitution damages paid by the party responsible for the nullity when a contract is declared null.¹⁴⁵

b. Ultra Vires

Ultra vires conduct usually coincided with an enterprise or its agents’ attempt to seize market opportunities by engaging in activities outside the scope of their own business. Again, the threat *ultra vires* posed to the traditional government micromanagement of state-owned enterprises made it impossible for the law to give it effect.

¹³⁹ *See id.* at 14.

¹⁴⁰ *See id.*

¹⁴¹ *See id.*

¹⁴² *See id.*

¹⁴³ The Collection, *supra* note 101, at 18.

¹⁴⁴ *See id.*

¹⁴⁵ *See id.*

In a 1985 case, the merchandiser of a company in the sale of agricultural products ordered 500 TV sets from a trading firm at a bargain using pre-prepared contract papers under the proper letterhead and seal of the company.¹⁴⁶ However, the leadership at the agricultural company did not confirm the contract but sent the trading firm a telegraph expressing their intention to rescind it. The trading firm insisted that all the form requirements had been met, and the contract was valid. Therefore, it requested that the court enforce the contract or award them a penalty of 5% of the contract price. The court annulled the contract because the scope of business of the agricultural company should be confined only to the sales of agricultural materials. The sale of TV sets is outside their scope of business, therefore the contract is absolutely null even though it met all the form requirements under the ECL.¹⁴⁷ As a result, the agricultural company neither had to perform the contract entered by their agent nor did they need to pay the penalty or damage.¹⁴⁸ The comment attributed the illegality of the contract to the company's contracting beyond its capacity for civil rights¹⁴⁹ and the agent's unauthorized contracting.¹⁵⁰

Not only would exceeding the scope of one's business make a contract null and void, moving up in the industrial chain in the same industry would produce the same result. In a 1984 case, a bicycle retailer tried to purchase bicycle parts directly from another retailer intending to assemble and eventually sell the bicycles.¹⁵¹ When the retailer could not receive the exact parts it ordered, it sued to enforce the penalty clause and demanded damages along with penalties for breach of contract.¹⁵² The trial court rescinded both its contracts and ordered the return of the payment and the goods that had been received.¹⁵³ The buyer appealed the decision. The appellate court not only reaffirmed the annulment of the contracts but also fined the appellant RMB 5,000 yuan¹⁵⁴ as a punishment for the illegal conduct. The assembling of bicycle parts and the sale of the assembled bicycles by a retailer was illegal because it exceeded the scope of business of the retailer and thus was considered *ultra vires*. According to the appellate court, it was also illegal to purchase the parts at prices above those

¹⁴⁶ See *id.* at 14.

¹⁴⁷ See *id.* at 15.

¹⁴⁸ See *id.*

¹⁴⁹ Capacity for civil rights means the qualification of a subject to enjoy rights and bear obligations under civil law.

¹⁵⁰ See The Collection, *supra* note 101, at 16.

¹⁵¹ See *id.* at 37.

¹⁵² See *id.*

¹⁵³ See *id.* at 38.

¹⁵⁴ See *id.*

set by the state and to plan to resell the assembled bicycles at even higher prices.¹⁵⁵ Such conduct was considered to have disrupted the socialist economic order and harmed the state and consumers' interests.¹⁵⁶

As we have seen, in all these cases, according to the pre-reform theories, any increase in price or deviation from the set scope of business by a single enterprise constituted opportunistic behavior that would harm the implementation of state economic plans and eventually, the interest of the collective system. However, when a growing market partially opened up and private enterprises started to emerge, the previous theories that allowed state to be the sole planner which could control all prices and allocate all resources were no longer compatible with the changes in the economy.

iii. Binding Force of Contract

The Communist party leadership realized that the rise of freedom of contract was unstoppable. It accorded more respect to party autonomy and downplayed the role of state planning. As we have seen, in 1993, the same time that the concept of socialist market economy was introduced, the ECL was amended to expand the scope of the persons who were allowed to enter economic contracts to all individual business households and peasants. Also, as we can see from the collection, courts tend to hold that a contract entered into autonomously is binding.

In the pre-reform era, as we have discussed, contracting parties could normally be very insensitive to the terms of contract¹⁵⁷ and would usually tolerate the defective and default of the other party's performance since the state would bear the loss or absorb the profits. However, when a profit retention scheme was introduced, SOEs started paying more attention to the performance of contracts, and, more importantly, the court started to take contracts arising out of mutual negotiations seriously.

In a 1984 case, when the seller of refrigerating equipment failed to tender the exact products ordered – short of 10 sets of modules due to the seller's neglect when placing the orders.¹⁵⁸ The buyer sued for the damages in the amount of RMB12,600 yuan caused by the defective tender and its disruptive impact on the buyer's production plans.¹⁵⁹ The defendant

¹⁵⁵ *See id.*

¹⁵⁶ The Collection, *supra* note 101, at 38.

¹⁵⁷ *See* POTTER, *supra* note 15, at 22 (known as “signing contract blindly, signing big contracts without investigation.”).

¹⁵⁸ *See* The Collection, *supra* note 101, at 57.

¹⁵⁹ *See id.*

confirmed the facts but disagreed with the scale of the damage.¹⁶⁰ In this case, the buyer was a train and auto repair firm that attempted to acquire refrigerating and ice cream making machines so that it could expand its scope of business to the sale of ice cream.¹⁶¹ It was also said that the firm did so specifically to help employ the adult children of the repair company employees.¹⁶² This conduct was an obviously *ultra vires*. However, the official comment acknowledged that the contract was valid and that the defendant should be liable for its breach.¹⁶³ The comment stated that the damage was excessive and should be reduced. In the end, the case was settled under court-supervised mediation. The seller agreed to deliver the modules they failed to deliver and pay RMB 200 yuan in damages.

In a 1985 case, a buyer returned 200 emergency lights they purchased from the seller and defaulted in payment when they tried but were not able to sell the lights over the market.¹⁶⁴ In the pre-reform era, such an attempt to back out a contract would have been excused. However, in this case, the court ruled the contract was concluded through mutual consultation between the parties for their mutual benefit. The contract did not violate either mandatory law or state policies, and therefore was valid.¹⁶⁵ According to the court, overstocking was not a valid ground to excuse contractual performance.¹⁶⁶ The court, to protect the interest of the contracting parties, cited article 38 of the ECL finding liability for the breach of contract, and ordered the buyer to make the payment it had failed to pay, to pick up the lights it returned to the seller and to pay the economic penalty incurred.¹⁶⁷ This case marked the court's respect for party autonomy, and the independent legal personality of the contracting party who bears contractual liability.

In another 1985 case, a county-owned retailer, refused to recognize and pay for a sales contract for the purchase of plywood flooring tiles entered during the administration of the previous legal representative, then general manager.¹⁶⁸ The defendant argued that because the contract was entered into during the administration of the previous general manager and Communist party secretary, the current manager had no authority to pay for

¹⁶⁰ *See id.*

¹⁶¹ *See id.*

¹⁶² *See id.*

¹⁶³ *See id.* at 58.

¹⁶⁴ The Collection, *supra* note 101, at 54.

¹⁶⁵ *See id.* at 56.

¹⁶⁶ *See id.*

¹⁶⁷ *See id.*

¹⁶⁸ *See id.* at 97.

the contract and no knowledge of it.¹⁶⁹ In addition, the defendant took advantage of the absence of the doctrine of apparent authority and argued that the merchandiser concluded the contract with the plaintiff-supplier without the consent of the then Communist party leadership at the retail firm.¹⁷⁰ The court acknowledged the validity of the contract because it was formed on the basis of “the principles of equal status and mutual benefit of the parties, mutual consultation, and compensation for equal values” and “consent was reached after the inspection of the plywood tiles.”¹⁷¹

The court ordered the defendant to render the payment under the contract by the end of the year. Nevertheless, it rejected the claim for an economic penalty for a non-legal reason- to accommodate the financial difficulties the defendant was undergoing.¹⁷²

The official comments reasoned that the enterprise was bound although the legal representative or authorized agent who entered into the contract had left office.¹⁷³ That person had entered into the contract on behalf of the enterprise, and the performance of the contractual obligations should not be affected by the change of personnel.¹⁷⁴

Such a development was in severe contrast with a 1980 case decided just before the enactment of the ECL. In this case, the court acknowledged that the obligation to manufacture qualified products was owed to the state rather than the other contracting party.¹⁷⁵ The manufacturer sued to enforce payment although the glass tiles they manufactured were substandard.¹⁷⁶ The court rejected their claim and said that the plaintiff failed to fulfill its obligation to the state by manufacturing sub-standard products.¹⁷⁷ The manufacturer was condemned for doing so and withdrew its suit upon the court’s recommendation.¹⁷⁸

iv. Loss Splitting

Even though several years into the economic reform there was a notable increase in contractual autonomy and in the incentive to make profits, the state remained the sole stakeholder in allocating losses. The state

¹⁶⁹ *See id.* at 98.

¹⁷⁰ The Collection, *supra* note 101, at 98.

¹⁷¹ *See id.*

¹⁷² *See id.*

¹⁷³ *See id.*

¹⁷⁴ *See id.* at 99.

¹⁷⁵ *See id.* at 58.

¹⁷⁶ The Collection, *supra* note 101, at 58.

¹⁷⁷ *See id.*

¹⁷⁸ *See id.*

was the sole victim of abrupt contracting and profiteering at the expense of the state policies and economic planning. This was especially true when hard budget constraints were not imposed so that SOEs could still compete with private enterprises while pursuing goals other than profit maximization. As a result, in giving remedies, courts tended to split the losses between the contracting parties regardless of who was liable so that the financial difficulties of one contracting party could be accommodated through a reduction of damages. As a result, SOEs that would have been closed down could stay in business, and the losses the system suffered could be spread among a few SOEs, or even among contracting parties that did not have government affiliation, such as individual business households (single family-owned proprietorships).

In a 1984 case, the defendant, an individual business household, refused to pay for the substandard silk weaving materials it had ordered from the plaintiff, a cotton factory.¹⁷⁹ The official comment acknowledged the fact that the quality of the products was substandard and that liability should be borne by the plaintiff.¹⁸⁰ However, through court-supervised mediation, the defendant agreed to pay for the material at a reduced price.¹⁸¹ The court's "careful and thorough work" on the case and the appropriate solution it provided were commended by the official comment.¹⁸²

In a very similar case between two SOEs where the defendant refused to pay for the cotton cloth they ordered from the plaintiff, the defendant's only argument was that it did not have the financial means to pay. Consequently, it only paid RMB 50,000 yuan out of the contract price at RMB 1,398,268.65 yuan one year after the partial payment of RMB 1,211,353.78 yuan was due.¹⁸³

The official comment explained that the contract was concluded through mutual negotiations without any violation of state law or policies and therefore it was a valid contract.¹⁸⁴ The defendant's default in payment constituted breach of contract. However, to accommodate the defendant's financial difficulties, under the court's supervision, both parties reached agreement that the defendant would pay for the rest of the RMB 1,211,353.78 yuan that was due at the time, but not the contract price of 1,398,268.65 yuan, and the plaintiff agreed to excuse the defendant from

¹⁷⁹ *See id.* at 78.

¹⁸⁰ *See id.* at 79-80.

¹⁸¹ *See id.*

¹⁸² The Collection, *supra* note 101, at 79-80.

¹⁸³ *See id.* at 80.

¹⁸⁴ *See id.* at 81.

performing the rest of the contract.¹⁸⁵ According to the collection, default in payment resulting from financial difficulties could be resolved by returning the products to the supplier.¹⁸⁶ The official comment considered it a sound solution to have the defaulted buyer return the products to the supplier. This way the loss suffered by the collective system was minimized.

In dealing with contract disputes, rather than engaging in legal analysis, the comment encouraged the courts to engage in ideological counseling¹⁸⁷ between the parties so that the supplier could understand the policy importance to accommodate buyer's financial difficulties while the buyer would appreciate the disruptive effect their default in payment had caused to the production. With mutual understanding, both parties should actively search for solutions that were most beneficial to the system under the court's supervision. Such solutions could be the return of the products, using other merchandises to substitute cash as a form of payment, or payment by installments, or promise to pay when the financial situation improves under the sponsorship of superior government authority.¹⁸⁸

A perfect demonstration of the courts' active role and flexibility in solving contracting disputes in order to serve the system rather than to respecting contracting parties' rights is a pre-ECL case decided in 1979. An SOE entered into a contract with another SOE at a materials trade fair to sell 54 tons of steel to a state-owned steel window manufacturer.¹⁸⁹ However, it turned out that the same 54 tons had been sold to a light industrial bureau for its affiliate factory even before the fair took place.¹⁹⁰ No written contract was signed, and no payment had been made by the bureau at the time the contract was entered into at the trade fair.¹⁹¹ Both buyers insisted that they be entitled to the steel. The bureau argued that their contract was entered first.¹⁹² Both the court and the official comment recognized only the second contract entered at the trade fair,¹⁹³ probably because only the second contract satisfied the written requirement. However, the court eventually ordered 30 tons of the steel be sold to the window factory and assigned to the bureau the other 24 tons.¹⁹⁴ The

¹⁸⁵ *See id.* at 80.

¹⁸⁶ *See id.*

¹⁸⁷ In such counseling, courts would educate parties what Communist ideology expects them to do. The aim would be for the parties to prioritize the interest of the collective system before their individual interest.

¹⁸⁸ The Collection, *supra* note 101, at 83, 84.

¹⁸⁹ *See id.* at 26.

¹⁹⁰ *See id.*

¹⁹¹ *See id.* at 91.

¹⁹² *See id.* at 27.

¹⁹³ *See id.*

¹⁹⁴ The Collection, *supra* note 101, at 27.

flexibility, creativity and discretion the court exercised in the situation was commended by the commentary. Such a solution did not harm the parties' interest while at the same time "enhanced the social economic efficiency."¹⁹⁵

V. CORPORATIZATION AND THE THEORETICAL INCOHERENCE

A. *Corporatization*

In an economy where private ownership and competitive markets are the norm, it is easier to justify the freedom of contract since a reasonable person should be allowed to dispose of his property and to contract to determine his own fate and bear the negative consequences accordingly. On the other hand, in an economy where a market is absent, state ownership of means of production is exclusive, and the allocation of resources is centralized, as in pre-reform China, every SOE exercises their operational management rights by entering into contracts on behalf of the state. It was consistent with the socialist theories to deny freedom of contract in order to prevent opportunistic behavior by these SOE managers, the agents of the state. The socialist theories were by and large coherent. However, in the first decade of Chinese economic reform, both theories became inapplicable to China. There was a rapidly growing private economy outside the dominant state sector, and a dual track price system that allowed market prices to exist in parallel of the fixed prices in the planned economy. This new paradigm created the theoretical nuance that would fit in contract theories in neither traditional socialist economy nor the Western capitalist model.

At the beginning, profit retention and increased autonomy brought efficiency and proper incentives back to State sector. However, due to the continued absence of a competitive market, and the information asymmetry that comes with it, the reform failed to resolve the problem of managerial opportunism that the pre-reform system aimed to prevent. Ten years into the economic reform, the economic efficiency and profitability of SOEs stalled. Low profitability became common among SOEs. For example, the after tax profit of SOEs decreased from 6.6% in 1987 to 1.8% in 1994.¹⁹⁶ Increased bank loans were made available upon request to support the SOEs at the below market rates. However, the number of non-performing loans continued to accumulate when the efficiency of the SOEs stalled. Corporatization was introduced to accelerate the reform progress.

¹⁹⁵ *See id.*

¹⁹⁶ *See* LIN, *supra* note 16, at 66.

As part of the small-scale privatization effort, the rise of stock exchanges and equity exchanges allowed private investors to become the minority shareholders of large scale SOEs. In addition, restructuring, as a popular device, was introduced to privatize inefficient small and medium enterprises. Both devices serve to further privatize Chinese economy. Nevertheless, in contrast to the former Soviet and East European models, no program allowed the wholesale divestment of state enterprises program to be undertaken.¹⁹⁷ As a result, no massive asset stripping took place that on the scale of that in the Soviet Union.

To facilitate the transformation of a planned economy to a market economy, the ECL was amended in 1993. The Company Law of China was also adopted in the same year.¹⁹⁸ The amended ECL added two types of family-owned sole proprietorships: peasant households and private-owned business households, as parties who are allowed to enter into economic contracts.¹⁹⁹ Also, in the amended article 7 of the ECL, violation of Communist Party economic policy was no longer a cause for nullifying a contract,²⁰⁰ which signified the end of the planned economy. The then-newly enacted Company Law did not limit legal persons to SOEs and therefore opened the floodgate to allow privately-owned enterprises to register as corporations and assume the status of legal persons.²⁰¹ In 1999, the Contract Law, a product of legal transplantation resembling the United Nations Convention on Contracts for International Sales of Goods (CISG), adopted freedom of contract as a basic principle.²⁰² Rules that one would expect in a major Western civil code are now in place to protect contractual autonomy and transactional safety. Parties now have the autonomy to decide whether to contract, with whom to contract, and on what terms. The doctrines of apparent authority, *ultra vires* activities and voidability were introduced. Upon breach of contract, the aggrieved party can now choose the form of remedy between monetary damages and specific performance. Plans and policies, which were once dominant, no longer play an official role in contracting and the Contract Law statute.

Nevertheless, it is not the case that the Statute is and shall be equally

¹⁹⁷ See Lan Cao, *The Cat That Catches Mice: China's Challenge To The Dominant Privatization Model*, 21 BROOK. J. INT'L L., 97, 106 (1995).

¹⁹⁸ Before the promulgation of Company Law, there were two separate statutes dealing with state-owned enterprises and privately-owned enterprises separately.

¹⁹⁹ See Economic Contract Law, *supra* note 118, art. 2.

²⁰⁰ However, this does not mean SOEs have stopped following state economic policies closely.

²⁰¹ 中华人民共和国公司法 [Company Law of the People's Republic of China], arts. 2 & 3.

²⁰² See 中华人民共和国合同法 [Contract Law of People's Republic of China], art. 4.

applied to all parties regardless of their ownership status. In the West, market competition and fiduciary duty hold managers accountable for their imprudent managerial performance. This is still hardly the case for Chinese SOEs. Even though reforms have been carried out to invigorate SOEs, the market is still not sufficiently competitive and fiduciary duty principles are ineffective in imposing the managerial accountability. The fiduciary principle, as in the West, functions to protect the principal's reliance interest. In China, without such a market, prices can be suppressed for policy reasons. Since SOEs are also pursuing goals other than profit maximization, the usual market indicator, profitability, does not provide sufficient information to the state. As a result, non-profitable transactions could be carried out for policy considerations. On the one hand, a low price itself is not sufficient to prove a SOE manager's breach of fiduciary duty. On the other hand, it is impractical and unrealistically expensive for the state, as the sole shareholder or controlling shareholder, to monitor the contracting of individual enterprises. Additionally, the state's low sensitivity to profits compared to private investors makes the state a passive principal who is not actively pursuing its own financial interest.

Behaviors of SOE managers, on the other hand, could not be controlled by an effective incentive structure that provides incentive compatibility. I described the problem in an earlier article as follows:

Managers in state-owned enterprises are government employees more than businessmen and lack personal incentives and financial stakes in running the business. Managers receive salaries that are comparable to government employees with similar bureaucratic ranks, and directors and officers can be laterally transferred to other government agencies in the event the SOE goes bankrupt. Since these quasi state-officials are not nearly as motivated as private entrepreneurs, since they are not accountable to shareholders for their grossly negligent business decisions, when it comes to decide whether a contract should be nullified.²⁰³

In a true market economy, contractual autonomy should extend to SOEs as well. The state-owned enterprises are no longer established for the sole purpose of implementing state policies. Most of them are for-profit and operate under the leadership of their own management rather than

²⁰³ Hao Jiang, *Enlarged State Power to Declare Nullity: the Hidden State Interest in the Chinese Contract Law*, 7 J. CIV. L. STUD. 147, 188 (2014).

government authorities. Therefore, SOEs are market participants whose interests should receive only as much protection and supervision as private parties. However, the state retains a supervisory power over the management through the authority of the State-owned Asset Supervision and Administration Commission²⁰⁴ and various ministries and financial regulatory bodies. At the same time, policy induced burdens, soft budget constraints, and artificial entry barriers still exist. On one hand, they burden SOEs; on the other, they help them survive market competition.

In order to better monitor SOE performance, many statutes, administrative regulations and departmental rules have been enacted since the late 1980s designed to curb managerial opportunism in SOE's and to realign the disparity between their goals and those of the state. In order to curb the managerial opportunism and prevent asset stripping, several regulations have been put in place to require asset appraisal, and, in major transactions, state approval in contracts disposing of state assets.²⁰⁵ The asset appraisal procedure might serve as an *ex ante* deterrent to asset-stripping. However, for the *ex ante* deterrent to function, when a flaw in the asset appraisal process is later detected, an *ex post* standard must be established to determine whether asset stripping took place. Such a standard should be the substantive fairness of the transaction. When the contract price was not substantively fair, courts, at the request of the aggrieved SOE, should be empowered to annul the contract when no legitimate policy or business reasons for the low price can be established. However, Chinese courts have claimed that they are not in a position to review the alleged unlawfulness in the asset appraisal procedure even when evidence shows the procedure was violated.²⁰⁶ Moreover, according to the court, violations in such procedures alone do not amount to asset stripping.²⁰⁷

²⁰⁴ SASAC was created in 2003 to exercise state's shareholder rights within the SOEs. SASAC has the authority to appoint the management personnel, supervise major management decision-making and the use of state-owned assets. See 国务院关于机构设置的通知 (国发(2008) 11号[State Council's Notice on Agency Creation] (Guo Fa (2008) No.11).

²⁰⁵ See, e.g., 中华人民共和国企业国有资产法 [State-owned Assets Law of the People's Republic of China] (adopted by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009); 企业国有资产监督管理暂行条例 [Provisional Methods on Supervision of State Assets Appraisal] (promulgated by the State-Owned Assets Supervision and Administration Commission, May 27, 2003, effective 2005); 国有股东转让所持上市公司股份管理暂行办法 [The Provisional Methods on Supervision of Holder of State Shares' Transfer of State Shares] (promulgated by the State-Owned Assets Supervision and Administration Commission, effective July 1, 2007), art. 7; 国有资产评估管理办法 [Rules on the Appraisal and Management of State Assets] (promulgated by the State Council of China, Nov. 16, 1991), art. 3.

²⁰⁶ See *infra* note 216 白商初字第231号 [(2013) Bai Shang Chu Zi No.231].

²⁰⁷ See *id.*

On the other hand, the state has rewarded SOE managers by giving out bonuses for making profits and punished them by cutting salaries for operating the SOEs at a loss. These efforts are designed to preserve state assets, encourage a market economy, and also increase managerial efficiency. The two goals seem to contradict each other. The first limits the freedom of contract beyond what one would expect from the statutory and doctrinal interpretations, such as freedom to decide contract terms or to set prices, and the second increases managerial and contractual autonomy. According to Yifu Lin, such reform efforts could not be successful and complete because of the lack of a fair and competitive market.²⁰⁸ Despite reform, SOEs continue to carry out non-profit driven goals to serve the state's policy and strategic interests. In order for SOEs to survive, the state must provide direct and indirect subsidies and soft budget constraints. Accordingly, profit level in a non-competitive market does not reflect the managerial performance. Consequently, as Joseph Stiglitz pointed out, without functioning market competition, a rational incentive structure cannot be formed.²⁰⁹ The absence of competitive market further warrants the deprivation of full enterprise autonomy to avoid asset stripping. Due to the economic reform, the doctrinal coherence of socialist contract theory was lost. As a result, courts are often at loss and decisions may vary from respecting the external formalism of the transaction to honor freedom of contract to substantive review of the fairness of the transaction in order to prevent asset stripping.

B. The Theoretical Incoherence

Though massive privatization of SOEs never took place in China as in the Central and Eastern Europe, privatization of small and medium SOEs and market capitalization of the non-controlling interest of the major SOEs allow private sector actors to acquire state assets through contractual transactions. Through these transactions, freedom of contract had been abused by SOE managers in pursuing personal agendas that are often incompatible with the interest of the principal, the state. Examples are selling state-assets too cheaply or choosing to contract with parties who are related to them or who most heavily bribed them. However, even when the managers are convicted for corruption or abuse of power by a government or SOE employee, the contract itself is still valid. The courts do not have a solid theoretical ground to annul such contracts on their own initiative or upon the request of the aggrieved party unless fraud or duress can be

²⁰⁸ See LIN, *supra* note 16, 125-153.

²⁰⁹ See JOSEPH E. STIGLITZ, *WHITHER SOCIALISM?* 111 (MIT Press, 1994).

proved.²¹⁰ Will theories deny there is a just price for things, as the value is subjective and “depends on the mere judgment of men.”²¹¹ Therefore, in principle, both common law and civil law rejected relief for an unjust price.²¹² However, the premise for such a view is that a reasonable person should determine his own fate by contracting and therefore bear the negative consequence of a bad bargain. However, this argument does not apply to Chinese SOE managers, who would contract on behalf of the state while having the state bear the negative consequence.

i. Abuse of Freedom of Contract

The principle of freedom of contract discourages courts from examining whether the price of a contract is just. However, given the absence of a competitive market and state’s inability to monitor every single contractual transaction carried out by SOE managers, it is unavoidable that freedom of contract will be abused in the sale of state assets, privatization of smaller SOEs, and many bidding procedures. SOE managers have the incentive to deal with their relatives, and with the people who bribed them most heavily or transfer the state assets into their own hands at lower than the market value. Though all such conducts are punishable by criminal law, contracts entered by these managers are not absolutely null. They should not be in principle. Even though SOE managers committed criminal conduct in contracting, the SOE might still have business or policy reasons to keep the contract. However, according to both the decisions of the Supreme Court²¹³ and the State Assets Law,²¹⁴ transactions that concern either the sales of small sized SOEs²¹⁵ or state assets, shall automatically be declared null if there was a malicious conspiracy that harms the state interest. Nevertheless courts, out of respect for freedom of contract, do not examine whether the contracts that result from corruption, bribery and

²¹⁰ Article 52, section 1 of the Contract Law provides a leeway for SOEs to back out a contract by arguing that state interest, which is represented by the SOE’s financial interest was harmed by fraud and duress, and the contracts, though for various reasons were not annulled as an annulable contract, could now be declared absolutely null. *See generally* Hao Jiang, *Enlarged State Power to Declare Nullity: the Hidden State Interest in the Chinese Contract Law*, 7 J. CIV. L. STUD. 147 (2014).

²¹¹ *See* GORDLEY, *supra* note 25, at 1592.

²¹² *See id.*

²¹³ 最高人民法院关于审理与企业改制相关的民事纠纷若干问题的规定 [Supreme Court Rules on various issues regarding civil disputes in restructuring of state-owned enterprises].

²¹⁴ *See* 中华人民共和国企业国有资产法 [Law on State-owned Assets in Enterprises of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2008, effective May 1, 2009), art. 72.

²¹⁵ In China, privatization of SOEs only extends to small and medium SOEs.

conspiracy were tantamount to stripping state assets. The passivity of judicial practice, in a sense, encourages the stripping of state assets.

In a 2013 case that concerns a dispute over the equity interest within a privatized former SOE, the court abstained from assessing the fairness of the price in a stock purchase agreement.²¹⁶ The plaintiff claimed that the methods used in the asset appraisal was inconsistent with the methods required by the *Provisional Methods on Supervision of State Assets Appraisal*²¹⁷ The court ruled that such a violation did not affect the validity of the stock purchase agreement.²¹⁸ The court reasoned that as the *Provisional Methods* is merely an administrative regulation, its regulations on the methods for asset appraisal are not mandatory requirements.²¹⁹ Therefore, the violation did not affect the validity of the contract.²²⁰ As to the potential harm to public interest, the court opined that its role is limited to examining the external form of the commercial transaction rather than its substance in order to protect the security of the transaction.²²¹ In addition, the court argued that since the form of the transaction complied with the legal requirements, the problems regarding the asset appraisal did not necessarily amount to a harm to the public interest.²²²

In a 2014 case, the County Administration of Forestry sued to annul a contract in which a house owned by its subsidiary SOE was sold to two individuals.²²³ The sale was made through a procedurally sound public bidding process. Nevertheless, the SOE general manager was later convicted of receiving bribes from the individuals that won the bidding.²²⁴ The court upheld the validity of the sales contract.²²⁵ The contract was the product of the genuine meeting of minds of the both parties, the SOE and the two individuals.²²⁶ The court reasoned that neither the corrupt manager nor the two individuals were a party to the contract.²²⁷ Moreover, the SOE

²¹⁶ See 张芸. 江苏省演艺集团 [Zhangyun v. Jiangsu Group of Performing Arts] (2013) 白商初字第231号 [(2013) Bai Shang Chu Zi No. 231]. (Qinhuai District Court of Nanjing 2013).

²¹⁷ See *id.*

²¹⁸ See *id.*

²¹⁹ See *id.*

²²⁰ See *id.*

²²¹ See *id.*

²²² See *id.*

²²³ 黟县林业局 v. 方山 [Yi County Forestry Bureau v. Fang Shan] 宣中民四终字第00105号 [(2014) Xuan Zhong Min Si Zhong Zi No. 00105] (Yuan Cheng Municipal Intermediary Court 2014).

²²⁴ See *id.*

²²⁵ See *id.*

²²⁶ See *id.*

²²⁷ See *id.* According to article 52, section 2 of the Contract Law, “malicious conspiracy committed to harm the state interest” will render a contract null and void.

manager's receipt of bribes is not sufficient to prove that there was a malicious conspiracy that harmed the state interest and the state assets were sold at a low price.²²⁸ The court again abstained from evaluating the fairness of the transaction when the evidence should have given rise to the presumption of assets stripping.

This pattern is consistent. In a 2013 Supreme Court case, the Supreme Court upheld the trial and appellate courts decisions to affirm the validity of the asset transfer agreement that allowed major state assets owned jointly by a wholly state-owned enterprise and a state holding enterprise to transfer the land use rights²²⁹ of certain housing to a Japanese invested company to offset debts in the amount of RMB three million yuan.²³⁰ The plaintiff sued to annul the contract because the asset transfer neither went through the required asset appraisal, or the public bidding process, nor did the transaction obtain the SASAC's approval.²³¹ Still, the Supreme Court agreed with the lower courts that failure to comply with these procedures was not sufficient to prove that there was harm to the state interest by a malicious conspiracy between the SOE and the foreign invested enterprise to transfer state assets at a lower price.²³²

Consequently, the court's passivity in intervening in these cases encouraged the abuse of freedom of contract and aided the SOE managers stripping state assets for their own benefits. In each of these cases, I would argue that, a conviction of bribery and corruption, or flaws in asset appraisal or the omission of such a procedure should be a reason to deny the SOE managers the same contractual autonomy in disposing of state assets as freedom of contract would allow in the West and allow courts to avoid contracts that were concluded for the sole purpose of asset stripping.

If Chinese law protects only external formalism in transactions where SOE decision makers do not have to bear the negative consequences of the contracting, freedom of contract will lose its value. If a party does not have to bear these consequences, it will not always look out for the best interest of the enterprise. Insensitivity and incompatible incentives arise. When the state has to bear the negative consequences of the SOE's disposing of state

²²⁸ *See id.*

²²⁹ There is no private ownership of land in China so land use right is the most ownership right a private party can have over the land.

²³⁰ *See* 陈发树 v. 云南红塔 [Chen Fashu v. Yunnan Hongta Group] (2012) 云高二民初字第1号 [(2012) Yun Gao Er Min Chu No.1]. *See also* 陈发树 v. 云南红塔集团有限公司 [Chen Fashu vs. Yunnan Hongta Group Co., Ltd.], (Sup. People's Ct. 2013)(China)(2013)民申字第2119号 [(2013)Min Shen Zi No.2119].

²³¹ *See id.*

²³² *See id.*

assets, the price of a contract and fairness matter. The will expressed by a contracting party to dispose of state assets for an unfair price should be invalid if the sole motive for the transaction was to strip state assets. It is one thing to allow private investors to decide whether the prices of their contracts appear advantageous to them. It is another to allow SOE managers to have the same level of freedom. Applying freedom of contract to SOEs to its full extent encourages the stripping of state assets. Denying it fully will make commercial dealings impossible in the Chinese society. In my view, freedom of contract should be the default norm, yet the just described call for an enhanced judicial review of the substantive fairness of the transaction should be adopted when the circumstances warrant it.

ii. Interference with Freedom of Contract

Conversely, examples can be found where the state interfered with contractual autonomy by allowing an SOE to renege a bad bargain. This is done through placing a suspensive condition in the contract that depends solely on the state's will or whim. If the state were a party to the contract, such a condition would be a potestative condition that would have rendered the condition null. However, technically, the state is not a party to the contract though it has a controlling equity interest in the contracting party and is financially affected by its own administrative decision that is under its unbridled discretion.

As we will see in the *Chen Fashu* case, when a private investor won a public bidding and was qualified to purchase state shares, it is not clear who is the appropriate state authority that gives the final approval when state assets are traded. This approval or disapproval may be given years after a contract is concluded. In the meanwhile, the validity of the contract continues to be uncertain. Moreover, the state does not have to give any reasons for disapproving a transaction. The SOEs will only go through the transaction when honoring the contract will not result in loss of state assets. This practice shields an SOE from the risk of price fluctuation and gives an SOE a free way out of a bad bargain.

In *Chen Fashu v. Yunnan Hongta Group*,²³³ Mr. Chen, a private investor entered a stock purchase agreement that allowed him to buy 12.32% of the tradable state-owned shares of Yunan Baiyao Corp. owned by a major SOE, Yunnan Hongta Group, at a price of RMB 2.2 billion

²³³ See 陈发树v.云南红塔 [Chen Fashu v. Yunnan Hongta Group] (2012) 云高二民初字第1号 [(2012) Yun Gao Er Min Chu No.1].

yuan.²³⁴ The contract was concluded in September 2009 and conditioned upon the approval of the superior government authority.²³⁵ However, the transaction was never submitted either to the direct supervisory ministry of the SOE, the ministry of finance, or to SASAC for approval as the contract or the state regulations required.²³⁶ Two years after the conclusion of contract and the tender of payment, the stocks had not been transferred to Chen.²³⁷ Chen finally sued to enforce the contract in December 2011 when the value of the stock purchased had more than tripled, and reached RMB 6.8 billion yuan.²³⁸ While the stock price was increasing, Chen repeatedly urged the defendant to perform the contract but was only told that the transaction was pending approval.²³⁹ Less than a month after the suit was filed, a separate company that happened to be Hongta's bureaucratic superior, China Tobacco Corp., issued a decision to disapprove the transaction.²⁴⁰ The trial court upheld the validity of the contract itself but refused to give Chen any remedies permitted under the contract, without giving reasons. When the case was appealed to the Supreme Court, the Court held that the contract did not take effect because the condition for state approval was not met.²⁴¹ Since there was no contract, the court granted restitution damages and ordered Yunnan Hongta to return the RMB 2.2 billion yuan with interests to Chen,²⁴² which was significantly lower than the current value of the stock. At the end of the day, the court allowed an SOE to back out of a fully negotiated contract between two sophisticated and resourceful parties with the sole purpose of preserving the value of state assets. The reality is that the current contract theory did not take a solid stance that will keep the court from invading freedom of contract and lending a hand to an SOE when the state assumes the role both as the referee and a player.

In this case, the appropriate supervisory authority was not SASAC or other government agencies but a centrally-owned SOE, China Tobacco Company that exercised the quasi-administrative function in disapproving the sales of state shares two years after the contract was concluded, the RMB 2.2 billion yuan purchase fund had been received when the stock prices had already tripled. The mechanism that conditioned the validity of

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ 陈发树 v. 云南红塔集团有限公司 [Chen Fashu vs. Yunnan Hongta Group Co., Ltd.], (Sup. People's Ct. 2013)(China) 民二终字第42号 [Min Er Zhong Zi No.42].

²⁴² *See id.*

the contract on appropriate government approval in fact shielded an SOE from bearing the negative consequences of contracting while placing all the risks on a private party. Both the provincial high court and the Supreme Court dismissed the claims for either specific performance, or alternatively, the expectation damage. In fact, all that Chen, the private investor, asked for in this litigation was to submit the deal to the superior government agency of the China Tobacco Company, the Ministry of Finance, for approval. Therefore, even if Chen ever succeeds in the litigation, it only meant Hongta, the SOE, would be obligated to perform its contractual obligation by submitting the deal for approval.²⁴³ Even then the Ministry of Finance has the unbridled discretion to disapprove the deal, and the law would not afford the private investors any remedy in that case. Nevertheless, both courts denied such a request.²⁴⁴

In my view, for freedom of contract to achieve theoretical coherence in China, it is important to require the expression of wills to be legitimate and to allow courts to evaluate the substantive fairness of a transaction. Such enhanced judicial scrutiny shall only be exercised upon the request of an SOE when its manager has been convicted of corruption and abuse of power, and when an SOE attempts to withdraw from a bad bargain that was fair upon its conclusion. In these circumstances, the will expressed of the parties is expressed for the sole purpose of stripping state assets or giving an SOE a free way out, and is not legitimate. In evaluating the substantive fairness of a transaction, courts should enforce a contract when an SOE refuses to perform to avoid a bad bargain in the name of protecting state assets or for the want of state approval. On the contrary, in finding that a transaction was substantively unfair and that the contract entered by an SOE was for the sole purpose of stripping state assets, the courts have rescinded the contract at the request of the aggrieved SOE. Nevertheless, when the disparity in price can be explained by business or policy considerations, courts should give deference to the contract terms and hold the contract valid.

²⁴³ See 云南白药股权官司调解未成：陈发树拒绝红塔只付利息 [Hongta Settlement fell through: Chen Fashu rejected Hongta's offer to return the fund and pay the interests], SINA (Dec. 6, 2013, 6:59 AM), <http://finance.sina.com.cn/chanjing/gsnews/20131206/065917548849.shtml>.

²⁴⁴ See *Chen Fashu v. Yunnan Hongta Group*, Yun Gao Er Min Chu No.1 (云高二民初字第1号) (Yunnan Provincial Higher People's Ct. 2012); see also 民二终字第42号 [Min Er Zhong Zi No.42] (Sup. People's Ct. 2013).

iii. When Fairness is Irrelevant

In general, outside the very specific circumstances discussed where freedom of contract might be abused or violated due to state ownership, freedom of contract should prevail. Fairness of the contract matters less when contracting parties are private parties who can determine their own fates and shoulder the negative consequences of contracting or when there is a policy reason for the disposing of state assets at a low price. Such reasons include taking care of SOE workers who have been laid off and administrative redistribution of state assets from one party to the other. Applying Gordley's theory, such transactions are not pure exchanges but really to exercise the liberality to confer benefits to the other party.²⁴⁵

In Chinese law, there are doctrines available to rectify one-sided contracts as in the Western law such as fraud,²⁴⁶ duress,²⁴⁷ mistake²⁴⁸, and procedural and substantive unconscionability.²⁴⁹

As we can see from the cases, when there is no significant state interest at stake and a policy reason to support a lower than fair market price, courts rule in favor of freedom of contract regardless of the actual fairness of contract.

In a 2012 appellate case regarding a dispute over the rent in a land contract, the appellate court affirmed the trial court's decision to uphold the lower rent specified in the contract and denied the SOE's claims that the

²⁴⁵ See Gordley, *Equality in Exchange*, *supra* note 1, at 1616, 1624.

²⁴⁶ Article 54 of Chinese Contract Law provides grounds for the voidable contracts. It provides:

A party shall have the right to request the people's court or an arbitration institution to modify or revoke the following contracts:

- (1) those concluded as a result of significant misconception;
- (2) those that are obviously unfair at the time when concluding the contract. *Zhonghua Renmin Gongheguo Hetong Fa 中华人民共和国合同法* [Contract Law of the People's Republic of China art. 54].

²⁴⁷ *See id.*

²⁴⁸ *See id.*

²⁴⁹ Procedural unconscionability corresponds to exploitation of the other party's weakness and is defined as "[o]ne party compelling the other side to express will in violation of his true will in time of the other's difficulty in order to seek illicit benefits and seriously impair the other side's interests." SUP. PEOPLE'S CT., OPINIONS OF THE SUPREME PEOPLE'S COURT ON SEVERAL ISSUES CONCERNING THE IMPLEMENTATION OF THE GENERAL PRINCIPLES OF THE CIVIL LAW OF THE PEOPLE'S REPUBLIC OF CHINA art. 70 (1988).

Substantive unconscionability, known as obvious unfairness is defined as "[o]ne party's violation of principle of fairness and compensation of equal value caused the disproportionality between an opposing party's rights and obligations by making use of his own advantages or the lack of experience of opposing party." *Id.* art. 72. Chinese law requires procedural unconscionability in addition to unfair terms to satisfy obvious unfairness.

contract was unenforceable because of obvious unfairness and changed circumstances.²⁵⁰ In this case, a wholly state-owned farm (“the farm”) signed a land contract leasing 4.82-mu of farmland to a then retiring employee, Teng Meicai (“Teng”).²⁵¹ The lease was for a 15-year term, from 2003 to 2018, at the annual rent of RMB 200 yuan/mu.²⁵² The rent was considered at the time of the lawsuit to be below market.²⁵³ The contract provided managing the leased farmland as Teng’s new employment. Since his retirement, Teng was categorized as self-employed and had to pay his own social welfare. Teng had since subleased the farmland to others using the rent as the main source of income, which was allowed under the contract.²⁵⁴ The farm had received the rent of RMB 200 yuan/mu until 2011.²⁵⁵ Then the farm sought to increase the annual rent to RMB 1,500 yuan/mu.²⁵⁶ When Teng refused to pay the higher rent, the farm sued in 2011 to either terminate the contract or increase the rent to the market level.²⁵⁷

The court requested a third party agency to appraise the fair rent of the farmland. It appraised the annual rent at RMB 1,447 yuan/mu for the period of 2011 to 2018.²⁵⁸ Nevertheless, concurring with the trial court, the appellate court upheld the original terms of the contract and ordered the state-owned farm to perform them. The court invoked the principle of freedom of contract, stating that “contract law protects the parties’ freedom to contract voluntarily and whatever terms are agreed by both parties that are not against the law are legally binding.”²⁵⁹ The court further reasoned that modification of a contract needs mutual consent that is lacking in this case.²⁶⁰ The court rejected the farm’s argument concerning the obvious unfairness of the low price for two compelling reasons. One is to interpret the purpose of the contract as a subsidy and the other is the significant disparity in financial capacities between the two parties. The rent constituted the distribution of welfare benefits, as seen by the fact that the farm cut Teng off the welfare benefits by allowing him to live off the leased

²⁵⁰ See 南宁市路东养猪场 v. 滕美才 [Nanning City Road East Farms v. Teng Meicai], (Nanning Municipal Interim. People’s Ct. 2012 (China)). (2012) 南市民二二终字第397号 [(2012) Nan Shi Min Er Er Zong Zi No. 397].

²⁵¹ See *id.*

²⁵² See *id.*

²⁵³ See *id.*

²⁵⁴ See *id.*

²⁵⁵ See *id.*

²⁵⁶ See *id.*

²⁵⁷ See *id.*

²⁵⁸ See *id.*

²⁵⁹ *Id.*

²⁶⁰ See *id.*

farmland and to sublease it.²⁶¹ Therefore, the RMB 200 yuan/mu rent was not subject to the market rent.²⁶² Also, having defined the purpose of the contract as a sort of subsidy, neither changed circumstances, obvious unfairness, or impossibility arguments were valid. The farm argued that terminating the contract or raising the rent is a means to prevent the dissipation of state assets, and the continued performance of the contract will affect the operation of the farm. Therefore, the court had to weigh the public policy of subsidizing a retiring SOE employee against the policy of preserving state assets. The court made the decision to prioritize the policy that is of greater assistance to the more vulnerable retiring SOE employee. The court reasoned that the farm has substantial financial capacity, while Teng was counting on the 4.82 mu farmland as the main source of his income.²⁶³ Also, the contract had been performed for ten years and only had five years remaining.²⁶⁴ The continued performance of contract would have only very limited impact on the farm.²⁶⁵ Therefore, the court upheld the validity of the contract terms and ordered the farm to continue the performance for the rest of the term.²⁶⁶

In another 2014 case, the validity of an asset purchase agreement was challenged when an SOE employee, Gao Wenjie, purchased RMB 6.67 million yuan worth of state assets at the price of RMB 3.66 million yuan.²⁶⁷ The SOE at the time, under the direction of the local government, was going through a restructuring process in which the SOE was sold to its employees.²⁶⁸ Gao acquired the state assets through an open bidding process under the supervision of the government.²⁶⁹ His purchase of the corporate assets and an equity interest were also affirmed by the government.²⁷⁰ The company and the other shareholders denied his equity interest, arguing to affirm the sale would be to encourage the stripping of state assets.²⁷¹ The court, however, affirmed the validity of the sale of the equity interest and the asset purchase agreement even though the price was lower than the

²⁶¹ *See id.*

²⁶² *See id.*

²⁶³ *See id.*

²⁶⁴ *See id.*

²⁶⁵ *See id.*

²⁶⁶ *See id.*

²⁶⁷ *See* 高文杰 v. 定西市熙海油脂有限责任公司 [Gao Wenjie v. Dingxi City Hee Sea Oil LLC] (Dingxi City Interm. People's Ct. 2014) (China). (2014) 定中民二初字第4号 [(2014) Ding Zhong Min Er Cu Zi No.4].

²⁶⁸ *See id.*

²⁶⁹ *See id.*

²⁷⁰ *See id.*

²⁷¹ *See id.*

market value.²⁷² The court reasoned that both parties agreed that the purpose of the asset transfer at the lower price was to implement the state policy of re-settling the former SOE employees after privatization.²⁷³ The *Provisional Rules on Transferring State Shares in Listed Companies by Holders of State Shares* allows holders of state shares to transfer their shares gratuitously to government agencies, public sector organizations, and wholly state-owned enterprises.²⁷⁴ Such transfers require a feasibility study, financial reports, legal opinions by law firms, development and restructuring plans, protocols to deal with the debts, and approval by the SASAC.²⁷⁵

VI. CONCLUSION

In the pre-reform Chinese economy when every business was owned by the state and no market competition was allowed, it made sense for the state to deprive enterprises of contractual and managerial autonomy. Freedom of contract was prohibited and the theories were geared towards the fairness of contracting to the collective system. Principles such as accommodation of each party's difficulties in contractual performance and loss splitting between the parties existed to lower the economic loss to the state. Also, Western doctrines of apparent authority and *ultra vires* were rejected. In China's pre-reform distorted economy, even to make a profit by reselling was regarded as illegal and punishable by penal law. Though the theories were coherent, the low efficiency and ineffective allocation of resources in the economy called for the reform of the state sector and the introduction of a private sector.

Unlike former Soviet countries, in reforming its economy, China did not implement massive privatization but rather introduced a private sector outside the state sector and invigorated the state sector gradually so it could compete with the private sector. Partial profit-related incentives and partial managerial and contractual autonomy were introduced to invigorate SOEs. However, the market was still not sufficiently competitive and profit alone does not serve as a sufficient indicator of performance. To date, SOEs still account for roughly half of the Chinese economy and state ownership is pervasive in virtually all industries, many of which do not serve public or policy interests. Market capitalization allows private investors to be the shareholders of large SOEs, while, in most circumstances, the state

²⁷² See *id.*

²⁷³ See *id.*

²⁷⁴ See 国有股东转让所持上市公司股份管理暂行办法 [The Provisional Rules on Transferring State Shares in Listed Companies by Holders of State Shares] art. 30 (China).

²⁷⁵ See *id.* art. 34.

maintains a controlling interest in virtually all major state enterprises. The controlling interest of the state is guaranteed by the fact that a majority of shares in the Chinese stock markets are not tradable. On the other hand, inefficient small and medium sized enterprises have been privatized in the name of restructuring. Regardless of ownership status, the lack of a competitive market will continue to allow conflicts of interest between the state and private investors and a conflict between incompatible incentives.

SOEs still carry out policy goals that are non-profit driven, and SOE managers make business decisions that are in alignment with their political responsibilities. Such decisions enhance the political legitimacy of the Communist Party of China and at the same time, serve to advance their bureaucratic careers. These decisions are not necessarily in the best commercial interest of the enterprises. Examples are managerial decisions to engage in major disaster relief efforts at the cost of the SOEs to gain political capital,²⁷⁶ overstaffing to lower the unemployment rates, providing essential services to the society at below market prices²⁷⁷ or listing overseas to attract political attention.²⁷⁸

As we can see in many post-reform cases, in the name of the preservation of State assets, the state or SOEs who have contracted with private investors shirk bad bargains that were fair upon conclusion of the contract. On the other hand, SOE managers, motivated by illegal self-interest, have sold off state assets or equity interests below the market values for the sole purpose of asset stripping. In these two scenarios, the expressed will of the SOEs is illegitimate and should not be honored. As a result, there are two conflicting tendencies in the decisions of courts. On one hand, courts have enlarged power to declare a contract void and give the SOEs a free way out of a bad bargain to safeguard the state's financial interest. On the other, invoking freedom of contract, courts have refused to examine the fairness of the contract price and whether the transaction was tantamount to asset-stripping even when the SOE manager was convicted of receiving bribery in selling the State assets.

Freedom of contract should be modified so that the will expressed by SOE managers does not have the binding force that it would receive in Western law when it does not serve the interest of SOEs, or shields an SOE

²⁷⁶ See Jiangyu Wang, *The Political Logic of Corporate Governance in China's State-owned Enterprises*, 47 CORNELL INT'L L.J. 631, 663-664 (2014).

²⁷⁷ See Justin Yifu Lin & Guofu Tan, *Policy Burdens, Accountability and Soft Budget Constraint*, 89 AM. ECON. REV. 2, 429 (1999).

²⁷⁸ See Mingyi Hung T.J. Wong & Tianyu Zhang, *Political Considerations in the Decision of Chinese SOEs to List in Hong Kong*, 53 J. OF ACCT. AND ECON. 435, 436-37, 445-48 (2012).

from the risks of contracting. Without a competitive market, any *ex ante* deterrent will not be effective without sufficient indicator of managerial performance. Logically, we will have to resort to *ex post* judicial review of the substantive fairness of a contract to determine whether the state asset has been stripped or freedom of contract has been abused by the state. Therefore, the victim of the illegitimate declaration of will should be able to sue to avoid it. Upon the request of the aggrieved SOE or private investors in an SOE, courts should reject their freedom of contract and declare the contracts void. An enhanced judicial scrutiny of substantive fairness of transactions should be introduced when the state circumvents freedom of contract to renege a bad bargain and when an SOE manager abuses his power to sell off state assets at a price that is tantamount to asset stripping. As a result, neither wills expressed by an SOE to shirk a bad bargain nor the wills expressed by an SOE manager to strip a state asset shall be valid.

These problems will continue to exist so long as the state maintains its dual role as a referee and a player. There will be a continual conflict of interest and incompatibility of incentives. The most effective solution would be to find an incentive compatible mechanism that would give state sufficient incentive to stay as a passive tax collector rather than a shareholder.

As in the Western experiment of government corporations, the state has the incentive to maximize its wealth through maximizing the wealth of enterprises that are fully or partially owned by the state. This could still be done by the state's administrative intervention. Even in the West, the state did not retreat from its active role as a shareholder role in mixed enterprises out of goodness of heart. The shift only occurred when state realized that its best interests were served by acting as an impartial tax collector rather than a biased shareholder.²⁷⁹ When this happens, freedom of contract, as in the West, might finally be applicable to China.

²⁷⁹ See generally Mariana Pargendler, *State Ownership and Corporate Governance*, FORDHAM L. REV. 2917, 2931 (2012).