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## Enlarged State Power to Declare Nullity: The Hidden State Interest in the Chinese Contract Law

Hao Jiang

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**ENLARGED STATE POWER TO DECLARE NULLITY:  
THE HIDDEN STATE INTEREST IN THE CHINESE  
CONTRACT LAW**

Hao Jiang\*

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#### ABSTRACT

This article is on the hidden state interest that article 52(§1) of the Chinese Contract Law protects and the questionable applicability of freedom of contract to Chinese state-owned enterprises (hereafter “SOEs”). In common law, fraud and duress make a contract voidable. In Western civil law jurisdictions, including Louisiana, fraud and duress make a contract relatively null. Article 52(§1) of the Chinese Contract Law renders a contract induced by fraud and duress absolutely null (null and void if using common law terminology) when state interest is harmed. At the same time, according to article 54 of the Contract Law, fraud and duress only make a contract relatively null just like in Western laws. The situation is further complicated by article 58 of General Principles of Civil Law (hereinafter “G.P.C.L.”), which renders all civil juristic acts absolutely null when induced by fraud and duress. To understand when a contract is null or annulable one has to reconcile these three statutory provisions and figure out what the state interest article 52(1) refers to. This article attempts to demystify this state interest through a historical survey of the evolution of contract law in the communist regime in China in comparison with the similar path Soviet civil law had gone through. If it simply means public interest, Chinese law is no different than the western counterparts. If it means something different, a secretive enlarged state power to declare nullity and invade freedom of contract might come with this law. Given the principal-agent relationship between the state and SOEs regarding the ownership rights of SOE assets, the absence of a sufficiently competitive market, the incentive incompatibility between the state

and SOEs, an enlarged state power over contractual autonomy is therefore implied and justified. This article suggests that such a state interest be state-owned enterprises' financial interest, which is different from public interest. As a result, freedom of contract shall not be applicable to Chinese SOEs when ownership rights and a competitive market are missing, and a different interpretation of nullity law should be adopted to protect SOEs' financial interest.

### I. INTRODUCTION

In Western civil law jurisdictions, a contract that violates the law, public policy or morality is absolutely null.<sup>1</sup> A contract that was entered into through fraud or duress is relatively null:<sup>2</sup> it is valid unless the victim of the wrongdoing asks to have it annulled.<sup>3</sup> There is good reason for the distinction. If a contract violates the law, public policy or morality, it should not be valid whether the parties wish it to be or not. If a contract is induced by fraud or

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1. See K. ZWIGERT & H. KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW 381 (3d ed., Tony Weir trans., Oxford 1998).

2. There is a conceptual difference between common law and civil law that can be reflected in the choice of terminology between voidable and relatively null. Common law contract law concerns the enforceability of a promise and the voidability of the contract is raised by the promisor as a defense to bar the enforcement of a promise. In civil law, a relatively null contract is valid until declared null by a court upon the request of the aggrieved party. China adopted the civil law approach and requires, when certain circumstances warrant a revocable contract, the aggrieved party to request the court to have a contract annulled or revoked. See Chinese Contract Law art. 54. Therefore, in this article, I refer to contracts induced by fraud and duress as "relatively null contracts" in conformity with the civil law tradition. Also, as appeared in the official translation of Chinese contract law, the term "null and void" was adopted to correspond to the concept of "absolutely nullity" in the mainstream civil law. In this article, I will quote the term "null and void" in reference to "absolutely null". The contracts that are relatively null are phrased literally as "revocable and modifiable" contracts in Chinese statutes. Chinese law gives the aggrieved party not only the option to nullify such contracts as they are "revocable", but also the power to modify the contract if they can reach agreement with the party at fault.

3. For example, under German law, a declaration of intention that is induced by fraud or duress, and therefore not genuine, is only voidable. See Bürgerliches Gesetzbuch [BGB] [Civil Code] art. 123 (Ger.). Under French law, error, violence, and deceit are vices to consent, making the contract relatively null. See Code civil [C. CIV.] art. 1109, 1110, 1113, 1116 (Fr.).

duress, it should be valid only if the victim so chooses. A buyer may have been fraudulently induced to pay 100 for goods with a market value of 80. In this case, he should be able to withdraw from the contract and get restitution damage- return the goods and get the 100 back. But, if the market price suddenly jumped to 120, he should be able to enforce it. He should also be able to enforce it if the goods are unique and worth more than 100 to him personally.

When relative nullity exists, why should the law allow the aggrieved party to determine the validity of the contract rather than declare the contract null and void *ab initio*? Clear classification of nullities had not been achieved by Roman law.<sup>4</sup> The modern classification of nullities and the widespread recognition of relative nullity in the civil law world owes to the rise of freedom of contract and will theories as a result of the 19th century liberalism and laissez-faire capitalism.<sup>5</sup> The reasoning behind relative nullity is usually that party will know his own interest better than the court and courts shall not interfere with contracting parties' free will, as dictated by the principle of freedom of contract. The wills of the contracting parties and their consent that relative nullity law tries to protect were not the central theme of contract law before the 19th century. However, since the rise of will theories and freedom of contract, the classical contract theory has "the tendency to attribute all the consequences of a contract to the will of those who made it."<sup>6</sup> 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."<sup>7</sup>

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4. The detailed accounts of the historical confusions can be seen in REINHARD ZIMMERMANN, *THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION* 679 (1990); see also Ronald J. Scalise Jr., *Rethinking the Doctrine of Nullity*, 74 *LA. L. REV.* 665 (2014).

5. The relevant provisions in French Civil Code are a typical product of this movement. See *supra* note 2.

6. P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 404 (Oxford 1979).

7. *Id.* at 408.

The core of freedom of contract is to give binding force to whatever is mutually agreed between the contracting parties.<sup>8</sup> Thus, to ensure freedom of bargaining, which was regarded as “the fundamental and indispensable requisite of progress”<sup>9</sup> by the 19th century economists, courts shall not step in to rectify an unfair bargain “since the force of competition will ensure fairness in terms and prices.”<sup>10</sup>

When the vice of consent in a contract only affects the interest of the contracting parties, nullity of contract can only be asserted by the party shouldering the negative consequence of this defect. The aggrieved parties are the only class of people the law of relative nullity is trying to protect, and the law gives them the option to confirm the act. Whenever they decide to confirm the validity of a defective contract that does not impair public or bona fide third party’s interest, they are acting in their own interest, and they are in a better position than the court to estimate the consequence of annulling a contract for themselves. In addition to protecting freedom of contract, the rules of relative nullity also operate to guarantee the safety of transactions. They give an incentive for parties to engage in business transactions by assuring them of their power to rescind the contract on their own initiative barring circumstances where the contractual defects will interfere with the interest of the public or a third party.

The unrestricted role the rise of capitalism and 19th century liberalism placed on the will has undoubtedly declined as so declared by Gilmore and Atiyah.<sup>11</sup> According to them, the destiny

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8. Article 1134 of the French Civil Code describes this principle as such: “contracts legally formed have the force of law for the parties who made them.” Chinese law adopted the idea of contractual freedom for the first time in 1999 through art. 4 of the Contract Law: “The parties have the right to lawfully enter into a contract of their own free will in accordance with the law, and no unit or individual may illegally interfere therewith.”

9. JAMES GORDLEY, *THE PHILOSOPHICAL ORIGINS OF MODERN CONTRACT DOCTRINE* 214 (Oxford 1991).

10. ATIYAH, *supra* note 6, at 405.

11. *See generally* GRANT GILMORE, *THE DEATH OF CONTRACT* (Ohio State Univ. Press, 1974); ATIYAH, *supra* note 6.

of freedom of contract is closely related to that of general theories of contract law, and neither of the two existed before the 19th century. The role of freedom of contract has been declining when the dominant role of the general theory of contract was gradually taken over bit by bit by the rise of protection of consumer interests in transactions where the bargaining powers are extremely unequal, limitations placed by special contracts such as the adhesion contracts, the emergence of regulatory law, and sophisticated commercial contracts that will allow parties to opt out of the requirements what freedom of contract would expect. 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 areas of the contract law mentioned above.

Nevertheless, contract law certainly predates capitalism and will theories and 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 without the will theories.<sup>12</sup> With all the difficulties and discredits mentioned earlier, does every industrialized society have to have contract theories that are based solely on the will and autonomy? Shall freedom of contract be applied to all human societies regardless of any features in its economy or are there certain prerequisites a society must entail for this doctrine to be justified and therefore become desirable?

This investigation on the relative nullity of contract in Chinese law serves as a test to examine whether freedom of contract, borrowed from the West and recognized as a fundamental principle of Chinese contract law, should be preconditioned on certain prerequisites such as the existence of private ownership and the availability of a competitive market. More specifically, I hope to test whether freedom of contract is applicable to Chinese state-

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12. See generally James Gordley, *Contract in Pre-Commercial Societies and in Western History* in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW (J.C.B. Mohr ed., 1997).

owned enterprises (SOEs) by investigating whether Chinese SOEs are afforded the option the relative nullity law provides theoretically to all contracting parties. I am of the opinion that, if freedom of contract is not applicable to China or Chinese SOEs, it is only reasonable that a different kind of relative nullity law should be adopted in China to serve the economic features unique to China.

In China, given the nuances arising from the inner-consistencies of various statutory provisions, the question whether a contract is absolutely null or relatively null is unclear.<sup>13</sup> At first sight, the law seems contradictory. Contracts are governed by the Contract Law enacted in 1999. Article 54 provides that, as in Western jurisdictions, a party who was induced to enter a contract by fraud or duress may have it annulled or modified. Article 52 provides that a contract is “null and void” if it “is concluded through the use of fraud or coercion by one party to damage the interests of the State” (§1); if it “harms the public interest” (§4); or if it “violates the compulsory provisions of the laws and administrative regulations” (§5).

If article 52 merely meant that a contract is null and void when it is illegal or offends public policy or morality, Chinese law would

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13. Western civil law scholars have raised the possibility of adding a third category of nullity, namely, mixed nullity for civil juristic acts or contracts that do not fit neatly within the traditional dichotomy of nullity. *See* Scalise, *supra* note 4. In determining the validity of contract or civil juristic act, Chinese law does introduce a third category: effect-to-be-determined contract or act, to put the legal effect of a contract or civil juristic act entered with inadequate civil capacity on hold pending on the confirmation or denial of the party with adequate capacity. The most relevant example is that a joint venture agreement between a Chinese domestic enterprise and a foreign enterprise is subject to state approval. Before such approval, the agreement is considered neither a valid nor an invalid contract. This situation is common in foreign investment transactions where the state will have paternalistic power over the validity of the contract. For example, in the United States, the President has the power to suspend or prohibit foreign acquisitions on the grounds of national security. *See* 50 U.S.C. app. §2170(d). This article focuses solely on the tension between relative and absolute nullity under Chinese law, and therefore consciously avoids the complications mixed nullity would add to Chinese nullity law.



be like that of Western jurisdictions. In the case of fraud or duress, a contract would be relatively null at the instance of the wronged party. In the instance of illegality or immorality, the contract would be absolutely null. But then there would have been no need for the statute to provide that a contract is absolutely null, not only when it violates the law, but when “the use of fraud and duress damage the interest of the state” (§1) or “malicious collusion committed to harm the state interest” when the contract neither “harms the public interest” (§4) nor violates any “laws” or “administrative regulations” (§5).

Suppose, however, that all contracts were deemed to affect the “interest of the state” or the “public interest.” As we will see, that was the official view before the introduction of elements of market economy in China. To the extent that view still prevails, every interference with the contracting by fraud and duress would “damage the interest of the state.” All contracts entered into by fraud or duress would be absolutely null under article 52(§1). But then, article 52(§1) would conflict with article 54, which provides that contracts are annulable for fraud and duress, yet only at the instance of the wronged party.

The law on the nullification of contracts induced by fraud or duress has been further complicated by article 58(§3) of the G.P.C.L.,<sup>14</sup> which was enacted in 1986 to provide general

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14. Article 58 of the General Principles of Civil Law of the People's Republic of China (GPCL—Adopted April 12th, 1986 and Effective January 1st, 1987) provides that:

- Civil juristic acts in the following categories shall be null and void:
- (1) those performed by a person without legal capacity for civil conduct;
  - (2) those that according to law may not be independently performed by a person with limited capacity for civil conduct;
  - (3) those performed by a person against his true intentions as a result of fraud, duress or exploitation of his unfavorable position by the other party;
  - (4) those performed through malicious collusion are detrimental to the interest of the state, a collective or a third party;
  - (5) those that violate the law or the public interest;
  - (6) economic contracts that violate the state's mandatory plans; and

provisions that were intended to operate as the Book I of the future Chinese Civil Code. Contract is regarded as a subcategory of “civil juristic acts” (Rechtsgeschäft) in civil law jurisprudence. Article 58 lists all the circumstances where a civil juristic act is deemed null and void. This laundry list covers all the circumstances under both article 52 and article 54 of the 1999 Contract Law without recognizing annulable civil acts. Under article 58(§3), a civil juristic act is null and void when a manifestation of intent is violated by fraud, duress and exploitation of the victim’s unfavorable position. The literal interpretation of this article would possibly mean fraud and duress will make a civil juristic act absolutely null regardless of whether the state interest is harmed, which conflicts with the two Contract Law articles mentioned above.

Perhaps, the most direct and effective way to assess the situation is to examine how courts interpret this provision in practice. However, this was not feasible until very recently. For many years, Chinese cases had not been available and accessible to general public and even the practitioners. In fact, most judicial opinions had been regarded as state secrets and made available only to the parties and court personnel. Only in the past few years had the newly-established search engines and legal research database started providing a select amount of cases to the public. For this project, up until the summer of 2013, I was only able to locate 23 cases decided under article 52 but none of the cases cited article 52(§1). In spring 2014, with more cases becoming accessible from the databases, I have identified 99 cases that cited article 52(§1). Through all these cases, one can easily detect the fact that courts are splitting on two issues: whether the state

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(7) those performed under the guise of legitimate acts conceal illegitimate purposes.  
Civil acts that are null and void shall not be legally binding from the very beginning.

interest here is equivalent to public interest or the SOE's interest; if and when state interest really means SOEs' interest, whether SOEs are afforded the option to keep the contract when there is a defect in consent induced by fraud or duress. I would like to suggest that such a hidden interest be the financial interest of SOEs that is different from public interest or any other interest law or public policy should protect in a market economy. Nevertheless, such interest should be otherwise protected given the absence of a sufficiently competitive market, and incentive incompatibility between the state as the owner of state assets and SOEs as the agents of the state. Also, I would like to argue that state should only exercise this enlarged power to declare the nullity of contract on the court's own initiative when there is neglect of duty, where the situation warrants no reasonable ground to justify the SOE management's failure to revoke the contract – the option afforded by article 54.

Determining which contracts are relatively null and which are absolutely null under Chinese law is not simply a matter of reconciling the three statutory provisions. It is a matter of reconciling the role of the state and the role of contracting parties in an economy which is in part state managed and in part market driven. To understand such a battle over contract autonomy, one has first to figure out what this secret state interest the Chinese laws are trying so hard to protect is. To see what is at stake, one must consider the role that contract and contract law played before and after private markets were introduced in the communist China.

## II. CONTRACT LAW UNDER THE COMMUNIST REGIME

### *A. 1950-1981: The Total Denial of Private Law and Freedom of Contract*

#### *1. The Economic Logic behind Nationalization*

Upon the establishment of the People's Republic of China in 1949, private ownership of land and industry was gradually

eliminated in order to implement the heavy industry oriented economic strategy. Following the massive nationalization of industry and commerce and the establishment of the state-owned enterprises (SOEs), a free and competitive market was gone and the price distortion emerged to artificially lower the cost in developing heavy industry. Such price distortion made it impossible for the state to evaluate the SOEs' management performance by using profit rate as the primary indicator, as it has been used in a market economy. Under these circumstances, without an effective governance model, the incentive incompatibility and information asymmetry between state and SOEs would not permit SOEs to have either the autonomy or business incentive in contracting.

The fact that communist China was founded upon a low level of industrialization and a backward economic structure made the government designate the development of heavy industry a priority, especially given the economic embargo due to the international disapproval of the new government and military threats China faced at the time.<sup>15</sup>

The profit generated by the same capital in light industry was 270% of that generated in heavy industry in 1957.<sup>16</sup> If given a choice, private investors likely had much less incentive to invest in heavy industry, therefore not meeting state expectations. Therefore, the nationalization of heavy industry and the replacement of privately-owned enterprises with SOEs became the alternative. Also, in order to reduce the production costs of heavy industry, it was essential to bring down the living costs of industrial workers.<sup>17</sup> Given the fact that private investors would have had no incentive to invest if the prices had to be distorted to serve the heavy industry, light industry was also nationalized.<sup>18</sup>

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15. See JUSTIN YIFU LIN, FANG CAI & ZHOU LI, CHINESE STATE-OWNED ENTERPRISES REFORM 23 (The Chinese Univ. Press 2001)

16. See *id.* at 23.

17. See *id.* at 24.

18. See *id.*

Following nationalizations, prices were distorted. A competitive and free market was no longer available. The implementation of state economic plans was considered the top priority for SOEs rather than profit maximization. All this appeared to be reasonable, since in a highly centrally planned economy, both profits and deficits can be artificially attributed to a particular industrial sector or a monopolized enterprise with the purpose of achieving the government's economic agenda. In such an economy, profit can no longer serve as an indicator in the evaluation of the business performance of SOEs.<sup>19</sup> When the market was gone, so was market competition. Without market competition, SOEs acted as monopolies in their designated regions. Profits and deficits can be easily manipulated by the state's decisions in price setting, prioritizing the development of an industry, or the manufacturing of certain products. It followed that the incentive to maximize profits should not even be permissible for the fear that SOE managers might try to intercept the production residuals at the expense of the implementation of state economic plans.<sup>20</sup> Nevertheless, the incentive incompatibility between the state as the owner of the state assets and SOEs as the managers of the state assets still existed. To protect the state from managers intercepting industrial residues and misappropriating state-owned assets, and to supply the lack of sufficient information in evaluating enterprise performance, it was required that the state be deeply involved in the daily operation of SOEs, which further took away the business autonomy and incentive of SOEs.

In the rural areas, the land reform took place which allowed the peasants to take over land from the landlords by force rather than by law or administrative decrees. Land ownership was since then monopolized by state and village collectives. Socialist agricultural communes were established in 1958 upon the enactment of the Resolution of the Politburo of the Central Committee of the

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19. *See id.* at 116.

20. *See id.*

Communist Party to bring about the agricultural collectivization and state monopoly of crops. The commune supplied all the economic resources and means of production equally to its members for free.

As a result of the ownership reform, the only type of ownership desired and allowed in the country's economy was public ownership.<sup>21</sup>

When private ownership disappeared in industry and commerce, and freedom of contract was completely taken away from enterprises, contract law was no longer considered private law and contracting became a mere documentation of state economic plans.

Together with nationalization and as part of its ideological campaign, the Chinese Communist Party followed the Soviet Union's experience in "casting out all prerevolutionary law" in order to "create a new heaven and a new earth."<sup>22</sup> As a result, all pre-existing laws enacted by the Nationalist Government such as the Civil Code were regarded as evil and something to be eliminated.<sup>23</sup> Both private economy and private contractual transactions lost legal legitimacy. With contracting parties losing all financial incentive to enforce a contract, nullification was no longer an issue. As a result, contracts other than economic contracts were either not regulated by law or outlawed entirely. The Chinese economic system in this period of time imitated the militant commune system operated in Soviet Union from 1918 to 1921 when private ownership and contract rights had been totally denied. The later Chinese economic reform resembles the New Economic Policy adopted by Soviet Union after the failure of the militant commune system. During both reforms, private ownership

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21. Of course, private ownership had to still exist in reality, especially when it came to personal property.

22. See JEROME ALAN COHEN, *CONTEMPORARY CHINESE LAW: RESEARCH PROBLEMS AND PERSPECTIVES* 324 (Oxford Univ. Press, 1970).

23. See MO ZHANG, *CHINESE CONTRACT LAW: THEORY AND PRACTICE* 2 (Martinus Nijhoff Pubs. 2006).

and private market were reintroduced along with the resurrection of legal institutions based on the civilian tradition. However, much like what happened later in China, the Soviet Union continued to exercise a central control over the economy and retained extensive powers to protect the state financial interest in the economy, thereby largely interfering with freedom of contract.

### *2. Militant Communism in the Soviet Union*

Militant Communism was a period of time from 1917 to 1921 when the Soviet government was fighting the civil war against its domestic opponents and foreign intervention. During this period of time, the Soviet government established a communist social order through massive collectivization and attempted to use central economic planning to replace markets.<sup>24</sup>

A series of fundamental legal and institutional changes began in 1918 that allowed the government to be the “exclusive owner of land, industrial and commercial establishments, and the only producer and distributor of commodities”.<sup>25</sup> The Soviet Union proclaimed its status as a communist country and at the same time destroyed the legality of private ownership. The right to contract disappeared along with property rights.

On November 30th, 1918, the Statute on the Judiciary abrogated all older laws.<sup>26</sup> On February 19th of the same year, all private land ownership was abolished.<sup>27</sup> Transactions regarding the right to use land were also prohibited.<sup>28</sup> Massive confiscations and nationalization took place. In 1918, several decrees annulled inheritance rights, stocks, bonds, and confiscated savings.<sup>29</sup> Banking, insurance and foreign trade were also subject to

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24. See VLADMIR GSOVSKI, *SOVIET CIVIL LAW* 10 (Univ. of Michigan Press 1946).

25. *Id.*

26. *See id.*

27. *See id.* at 10.

28. *Id.*

29. *Id.*

government monopolies.<sup>30</sup> By June 1919, copyrights and patents became subject to government monopoly.<sup>31</sup>

The government ownership of land and monopoly of crops and grains was enforced through the establishment of socialist agriculture communes. Special military detachments were sent to villages to collect the crops.<sup>32</sup> Peasants could only keep the crops and grains needed for their bare consumption. The surpluses above those needed for consumption had to be delivered to the government at “fixed prices equal to confiscation”.<sup>33</sup> All private trade in food was forbidden.<sup>34</sup>

The Supreme Economic Council was established in 1917 to manage all the state owned enterprises and confiscate private enterprises. In 1920, in order to inhibit the undesirable growth of the private businesses, the council issued an order nationalizing “all industrial establishments employing ten or more workers, or even five or more workers if with motorized installations.”<sup>35</sup> Following the massive confiscation and governmental regulations, from 1918 to 1920, all business initiatives were barred as were private property rights.

Soon enough, the omnipotent state role replaced the private law and the rigorous state planning left no place for contracting.

According to Goikhbarg, private law such as contract law was almost entirely absent during the period of militant communism with one exception, the contract of a village with the shepherd of the community herd.<sup>36</sup>

In 1921, a famine ended militant communism. The New Economic Policy was introduced and a Russian Soviet Federative

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30. *Id.*

31. November 26, 1918, Russian Soviet Federative Socialist Republic (R.S.F.S.R.) Laws 1918, text 900.

32. April 22, 1918, R.S.F.S.R. Laws 1918, text 432; June 11, 1920, R.S.F.S.R. Laws 1920, text 295; March 13, 1922, R.S.F.S.R. Laws 1922, text 266.

33. R.S.F.S.R. Laws 1917–1918, text 468.

34. R.S.F.S.R. Laws 1917–1918, text 346, §19.

35. R.S.F.S.R. Laws 1920, text 512, §546.

36. *See* GSOVKI, *supra* note 24.



Socialist Republic (R.S.F.S.R.) Civil Code was enacted in 1922, heavily influenced by the German Civil Code. Starting in May 1922, some confiscated properties were returned to former owners.<sup>37</sup> Any new confiscation was prohibited for the future.<sup>38</sup>

*3. The Total Denial of Private Ownership and Contract Law as Private Law in China*

As had happened in the Soviet Union after 1917, rigid state planning took place in China in the 1950s, leaving no place for autonomy in contracting.

As in the Soviet Union, given the fact that all means of production were now controlled by the government on behalf of every citizen, the only legally permissible contracts became economic contracts. As a consequence, only SOEs and government organs were allowed to contract.<sup>39</sup>

Nevertheless, the nationalization of means of production and private ownership along with the repudiation of all preexisting contract laws did not mean that no rules were in place to regulate contracts. It is said that, “up to 1958, 66% of 4000 regulations dealt with the national economy.”<sup>40</sup> Most remaining laws regulating contract were provisional decrees that were enacted to implement the state economic plans.<sup>41</sup> For example, contracting was regulated by *Provisional Methods on Contractual Agreement*

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37. *Id.*

38. *Id.*

39. See the Administration Council Commission of Finance and Economy, *Provisional Methods on Contractual Agreement Made between Government Agencies, State Enterprises, and Cooperatives* arts. 2–5 (1950), See MO ZHANG, *supra* note 23, at 3.

40. Gene T. Hsiao, *The Role of Economic Contracts in Communist China*, 53 CAL. L. REV. 1029 (1965).

41. The author is not arguing that there were no customs or informal local rules that might have been dealing with contracts in the civil law sense in Chinese society. However, whatever informal rules and dispute resolution mechanisms that might have been available before the economic reform at the end of 1970s, they were unofficial rules not recognized by the state and the activities that they dealt with were not regarded as contracting by the state until 1999 when contract law was finally defined as civil law.

*Made between Government Agencies, State Enterprises, and Cooperatives* (hereinafter “Provisional Methods”), which was issued in 1950 by the Commission of Finance and Economy under State Council (the equivalent of the Supreme Economic Council in the Soviet Union).<sup>42</sup> In 1963, the Commission on Finance and Economy issued another administrative regulation titled *Tentative Methods Regarding Mining Products Ordering Contracts* (hereinafter “*Tentative Methods*”). Other Ordering Contract Regulations were issued during this period.

Under the Provisional Methods, a contract was an economic act subject to state control.<sup>43</sup> The aim of such contracting activity was to distribute the resources and products according to rigid state economic plans and to satisfy every citizen’s quota. This is akin to a system in which the state is a big company that employs every citizen and everyone lives for free without drawing a salary.

During this so-called “lawless” era, the validity of contract was not even a practical legal issue and was never worth fighting for. Therefore, there was no mention of the nullity of contract in the *Provisional Methods* and *Tentative Methods*. The purpose of contracting was to “ensure the conscientious implementation and all-around fulfillment of the state plan.”<sup>44</sup> In accordance with this principle, parties entered into contracts not to maximize their profits but to serve the state interest. No legal rights were vested in the hands of contracting parties. It can be inferred that no contract could be entered into except to carry out the state economic plan. In such a context, it made sense that parties would not have to bear the risk of financial loss. Actually, at that time, all businesses were owned by the state, which provided 100% of the enterprise

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42. See MO ZHANG, *supra* note 23, at 3.

43. See *id.*

44. See the Administration Council Commission on Finance and Economy, *Tentative Methods Regarding Mining Products Ordering Contracts* art. 2 (1963).

equity.<sup>45</sup> Each individual business entity had neither an independent budget nor independent financial status.<sup>46</sup>

As Pitman B. Potter described:

Enterprise budgets were fixed and were generally unaffected by the nonfulfillment of contracts. Enterprise managers bore very little responsibility for losses caused by nonperformance of contracts, since such losses were generally made up by the state, either through an adjustment of the aggrieved party's planned production quota or by directly absorbing the deficit suffered by the aggrieved party.<sup>47</sup>

Under the 1950 Regulations, all contracts had to be registered at the People's Banks,<sup>48</sup> if the payment could not be processed immediately, and contracts, upon conclusion, had to be filed with the superior government and its economic commission, and also filed in the record of the department of treasury.<sup>49</sup> Compulsory dispute resolution mechanisms were in place before a contract dispute could be adjudicated by a court. Disputes regarding to nonperformance or breach of contract would have to be first submitted to a higher governmental authority for mediation since all businesses were owned by the state, and operated in the same way as a government agency.

If both parties were from the same province or circuit, their disputes had to be submitted to the higher level government's economic commission.<sup>50</sup> If the parties were from different provinces or circuits, the disputes had to be submitted to the

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45. Capital structure of SOEs include 100% of state equity and zero debt. See JIAN CHEN, *CORPORATE GOVERNANCE IN CHINA* 52 (Routledge 2005).

46. See PITMAN B. POTTER, *THE ECONOMIC CONTRACT LAW OF CHINA, LEGITIMATION AND CONTRACT AUTONOMY IN THE PRC* 32 (Univ. of Washington Press 1992).

47. *Id.* at 27.

48. The People's Bank is the central bank of China and the regulatory body of China's financial institutions.

49. Provisional Methods on Contractual Agreement Made between Government Agencies, State Enterprises, and Cooperatives art. 10 (1950).

50. See *id.* at art. 10.

economic commission under the central government.<sup>51</sup> A suit could only be filed in court when such arbitration or mediation from the higher authority could not solve the disputes.<sup>52</sup> Even when a suit was eventually filed in court, it would probably not concern the validity of contract. At first, government-run businesses had no concern whether a contract had been concluded legally, and whether the parties' declaration of intention was genuine. Since contracting was merely a form for recording state economic plans, contracting parties signed contracts simply to implement the executive order from higher government authorities, which excluded any autonomous intention on the part of the parties. Therefore, vices of consent, such as fraud and duress, as understood in Western law, did not really violate a contracting party's consent. Moreover, even if fraud and duress did violate one contracting party's financial interest, the loss suffered by the innocent party would be borne by the state and the unjust enrichment that resulted would also be absorbed by the state.

The major dispute a court might be dealing with in that time would be the failure to perform a contract. When this happened, a contracting party could not choose the form of remedy, and no monetary damages were available. The primary remedy was always specific performance.<sup>53</sup> When there was a late delivery, the remedy would probably "take the form of an apology and a promise to deliver as soon as possible."<sup>54</sup>

Therefore, from 1950–1981, Chinese contract law was pure public law. The Western idea of freedom of contract, which is based on theories of will and the declaration of will, was not even remotely applicable in China.<sup>55</sup> If German contract law can be

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51. *See id.*

52. *See id.*

53. *See* POTTER, *supra* note 46, at 42.

54. *Id.*

55. *See* ZWEIGERT & KÖTZ, *supra* note 1, at 326.

criticized for “containing only a few drops of social oil,”<sup>56</sup> Chinese law, at that time, could be said to contain nothing but “social oil.”

*4. 1981–1999: Fraud and Duress Make a Contract Null and Void*

The Third Plenary Session of the 11th Communist Party of China Central Committee Meeting, held in 1978, changed the direction of Chinese economy. The “Reforming and Opening Up” policy was adopted at this meeting. The lawless era ended as soon as China reopened its door to the world in 1979. The first contract law statute, called Economic Contract Law (E.C.L.), was drafted in 1980 and became effective in 1981. The E.C.L. was the law that governed domestic contracts. Another statute, the Foreign Economic Contract Law, was enacted to regulate contracts entered into with foreign parties. A third statute, the Technology Contract Law, was also adopted to govern technology related contracts. The concepts of private ownership and private economy were no longer prohibited and were reintroduced as “a supplement to the socialist economy”.<sup>57</sup> As a summary of the previous administrative regulations, the E.C.L. was an essential component to carry out the rigid state economic plan while at the same time allowing the increased autonomy that an open market and private ownership economy required. The E.C.L. was enacted with the purpose of “ensuring the fulfillment of state plans.”<sup>58</sup> Further, following this non-civil law definition, the E.C.L. allowed only legal persons to be the parties to an economic contract.<sup>59</sup> Under this article, economic contracts were defined as “agreements between legal entities for the purpose of realizing certain economic goals and specifying each other's rights and obligations.”<sup>60</sup> While maintaining the concern with economic law, certain features of

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56. See BASIL S. MARKESINIS, GERMAN LAW OF CONTRACT 45 (Hart 2006).

57. See Constitution of the People's Republic of China art. 11.

58. See Economic Contract Law of the People's Republic of China art.1

59. See *id.* art. 2.

60. *Id.*

civil law emerged for the first time in the legislative history of the People's Republic of China. The contracting party, for the first time, had a lawful interest in contracting<sup>61</sup> and contracting parties' autonomy in contracting was recognized and protected.<sup>62</sup> Along with increased autonomy, enterprises began to have independent financial status and to bear contractual liabilities. Still, by the time of the E.C.L.'s enactment, the effect of a planned economy was dominant and the hard-won autonomy was very limited. The state was still responsible for setting the market prices for products according to planning. According to the E.C.L., the contract price could only be negotiated when the state policy permits.<sup>63</sup>

As a result, the concept of the nullification of contract was introduced for the first time. The E.C.L., however, did not distinguish relatively null contracts from absolutely null contracts. It annulled the contracts that might be deemed relatively null under French and German law.<sup>64</sup> According to the E.C.L., all the following contracts are deemed null and void:

- (1) contracts in violation of the law or state policies and plans;
- (2) contracts signed through the use of fraud, coercion or similar means;
- (3) contracts signed by an agent beyond the scope of his power of agency, or contracts signed by an agent in the name of his principal with himself or with another person whom he represents; and
- (4) economic contracts infringing on the interests of the state or the public interest.<sup>65</sup>

The striking effect of this article was that violation of state plans was one of the grounds to rescind contracts, and the

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61. *Id.* art. 1.

62. *Id.* art. 5. This article provides: "Economic contracts must be made according to the principles of equality and mutual benefit, agreement through consultation and compensation of equal value. Neither party is allowed to impose its will on the other, and no unit or individual is allowed to interfere illegally."

63. *Id.* at art. 17(3), art. 23. Prices for both sales and lease contracts can be negotiated by parties when prices are not set by the State.

64. *See id.* art. 7.

65. *Id.* at art. 7.

existence of fraud and duress made a contract absolutely null rather than relatively null. Also, acting beyond the scope of authority rendered a contract null without recognizing later ratification by the principal as a cure for nullity. This clear cut solution as to defective contract was a reflection of the strong sense of protection of state economic interest under which the protection of private parties' interest was secondary. By this time, freedom of contract was not yet introduced. Also, protecting the safety of transaction and bona fide third party were significantly outweighed by safeguarding the state interest.

Though state control had been somewhat relaxed to leave room for a private economy and private market, the planned economy remained dominant. It might sound unsophisticated, by modern continental civil law standards, to deprive the parties from contract autonomy and to regard all annulable contracts as already null and void. Nevertheless, it was an understandable result given the historical context in China at that time in which the state had to intervene and declare a contract null when the majority of legal persons, as SOEs, didn't have contractual autonomy and business incentive to enforce their contractual rights on behalf of the state.

In the early stage of the economic reform, the state's financial interest in carrying out the economic plans without interference by fraud and duress was superior to the protection of the small scale privately owned enterprises' business autonomy in deciding whether to annul a contract when their consent was violated. After all, the overriding purpose of contracting was to meet the needs of the production and business operation under the mandate of the state plans.<sup>66</sup> Many times, contracts had to be concluded under the quota provided by the state and the conclusion of the contract had to be authorized by a higher government authority.<sup>67</sup>

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66. See MO ZHANG, *supra* note 23, at 32 (Quoting SU HUIXIANG, THEORY OF ECONOMIC CONTRACT LAW 3-5 (Liaoning People's Press 1990)).

67. See *id.* at 48. This situation happens when the business transactions concerning products and items fall within the scope of state mandatory plans.

On the other hand, in contrast to the West, where contracting is a result of business judgment, the majority of the contracting parties in China were simply carrying out the daily tasks assigned by higher authorities. Therefore, it made sense to consider fraud and duress as offenses to public policy and harms to public interest. In Western law, contracts in violation of public policy or morality are universally regarded as absolutely null or void. Moreover, given the fact that when the E.C.L. was enacted, virtually all business entities allowed to contract at that time were owned by the state, and consequently no private interest could have been harmed by the state intrusion in nullifying all contracts concluded by fraud and duress. At the beginning of the economic reform, private parties were simply not within the purview of the E.C.L.

As a contract under the E.C.L. was not essentially a civil juristic act, and no private interest was involved, the only party bearing the loss caused by fraud and duress was the state. Therefore, it seemed reasonable for the state to interfere with the validity of all such contracts and to rescind them.

*5. 1993–1999: The Emergence of a Market Economy and the Obsolescence of the E.C.L.*

*a. Emergence of Private Ownership*

Starting in 1980, a private economy first appeared among the peasants' households when a land tenure system named the Land Contract Responsibility System was established. The state allocated the cultivated land to peasant families. Families, as the basic units, were responsible for producing a certain amount of grain according to their assigned quota. Farmers were also allowed to keep the surplus as their own when exceeding the quota. The emergence of surplus created trade markets within each village neighborhood that sold exclusively agricultural products. This reintroduction of private ownership gave the farmers an incentive to produce more. Private ownership was soon extended to urban



cities where privately owned business households were allowed to operate. Such business entities were owned by individuals and their families, without employees outside the family.<sup>68</sup> This small-scale business economy was favored by the Communist Party. A party policy would soon allow these privately owned businesses to hire employees, under the cover name of training “apprentices.”<sup>69</sup> However, according to an administrative decree issued by the State Council, the number of employees such privately owned businesses were allowed to hire could not exceed seven.<sup>70</sup> This limit was placed to make sure that private business could only operate on a small scale so that state ownership would still be dominant and the foundation of communism would not be threatened. However, over the next few years, this restriction was not strictly enforced, and economy based on private ownership grew rapidly.

*b. State-Owned Enterprise Reform to Allow Autonomy and Incentives*

The state-owned enterprise reform in China differs from similar reforms in Eastern European and Latin American countries where massive privatization took place.<sup>71</sup> The Chinese SOE reform has been mainly about allowing SOEs to acquire limited business autonomy and benefit from economic incentives rather than divesting SOEs and introducing a sufficiently competitive and free market. Admittedly, allowing economic motive improved SOE performance and efficiency, whilst a mere increase of autonomy and incentive does not guarantee the continued improvement of

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68. In Marxism, capitalists, as business owners, obtain undue surpluses from the exploitation of their employees. Employment with private employers was deemed as an inherent feature in the capitalism that should not be allowed in communist China.

69. Implementing Rules on Urban Individual Business Households art. 4 [城乡个体工商户管理条例Cheng Xiang Ge Ti Gong Shang Hu Guan Li Tiao Li].

70. *Id.*

71. See generally WORLD BANK, BUREAUCRATS IN BUSINESS (Oxford Univ. Press 1995)

SOE performance.<sup>72</sup> Moreover, the pre-existing incentive incompatibility and the information asymmetry between the state and SOEs were not effectively addressed in the economic reform. State interference with freedom of contract is still necessary to effectively prevent SOEs from maximizing their own interest that can be incompatible with the state economic goals.

Following the expansion of autonomy in the privately-owned business, starting in 1984, a similar trend occurred among state-owned enterprises as well. On May 10th, 1984, an administrative decree entitled “Provisional Regulations concerning the Expansion of Autonomy for State-owned Industrial Enterprises” was issued by the State Council. Several measures have been taken since then to allow more autonomy in the operation of state enterprises and to motivate employees. According to the decree, the SOEs were allowed to sell their above-quota production at their discretion and could even sell 2% of the planned production quota.<sup>73</sup> For the goods at the SOEs’ disposal, SOEs can set the price within the range of 20% less to 20% above the state price.<sup>74</sup> This was a change in the over-centralized price control in China. In 1979, there were 256 industrial products whose prices were subject to mandatory state planning.<sup>75</sup> By 1984, this number was reduced to 60.<sup>76</sup> The trend has continued: the products whose prices are set by the state now account for only 5% of those in the market.

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72. Behavioral studies have shown that performance is not always proportional to economic motive. And SOE reform in many other countries have reached the consensus that, besides improving incentive structure, successful SOE reforms also come with introducing competitive and free markets, toughen SOE financial budgets, and divestiture of SOE ownership, etc. See WORLD BANK, BUREAUCRATS IN BUSINESS, *supra* note 71, at 5. As a result, mere increase of incentive doesn’t lead to better performance of SOEs.

73. *Provisional regulations concerning the expansion of autonomy for state-owned industrial enterprises* (Quoted in SHAHID YUSUF, UNDER NEW OWNERSHIP: PRIVATIZING CHINA’S STATE-OWNED ENTERPRISES 56 (Stanford Univ. Press (2006)).

74. *Id.*

75. *Id.*

76. *Id.*

Another effort to motivate the SOE workers is to link their work performance with profits and abolish their employment tenure. The decree also allowed up to 3% of industrial workers to receive merit raises<sup>77</sup> and by 1988, 60% of industrial workers were subjected to a wage scheme that links their salaries to the profits of the SOEs.<sup>78</sup> Also, starting in 1986, a new system was adopted to deny life time employment to employees newly hired by the SOEs.<sup>79</sup>

The business autonomy of SOEs was further promoted by the *contract responsibility system*, which was adopted in 1987.<sup>80</sup> Under this system, SOEs will sign a performance contract with the government, whose terms will extend for at least three years. These contracts were all written negotiated agreements specifying business goals for the SOEs to achieve within a given time frame.<sup>81</sup> This scheme allows the SOEs to retain a large share of the profits and arrangements were made to divide the cash flow between the SOE and the government.<sup>82</sup>

After over a decade of SOE reform, business autonomy greatly increased as a result, nevertheless, such autonomy was still limited and under the supervision of the state. As a survey conducted in 1994 suggested, daily operational rights had been delegated to most of the SOEs while the autonomy to make major business decisions such as mergers and acquisitions, investment, authority to conduct international trade was reserved to a small percentage of the SOEs.<sup>83</sup> According to this survey, 94% of the SOEs had acquired autonomous decision making rights of production and operation, 90.5% had acquired product sales rights, 95% acquired product sales right, 86% had acquired the wage and bonus

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77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 59.

81. *Id.*

82. *Id.*

83. See JUSTIN YIFU LIN ET AL., *supra* note 15, at 61.

allocation rights, 73.6% had acquired product pricing rights while on the other hand, only 25.8% of SOEs had acquired import and export rights, 46.6% had acquired asset disposing rights, 39.7% acquired the joint operation and acquisition rights.<sup>84</sup>

Still, the benefits of the increased autonomy is limited by the facts that prices are still not completely determined by market, state policy burden and corporate social responsibility results in the overstaffing in virtually all SOE, which still hinder the efficiency of SOEs. Without a sufficiently free and competitive market in place, profit cannot serve as a sufficient information indicator of SOE performance. The budget constraints on SOEs are not hard enough and bank loans are still available upon request with interest rates well below the market rates even when the banks are well aware that this is risky lending. Moreover, the fact that the state was the only or majority shareholder made it impossible for these SOEs to adopt effective corporate governance structure.

As a result, the increased autonomy of SOEs is still not the same as that of privately-owned enterprises in the West.

*c. Introduction of Socialist Market Economy*

To reflect and support these unstoppable changes in the country's economic system, the concept of socialist market economy was introduced by the Party in 1993 at its 14th Central Committee Meeting. Since then, in theory, means of production and products should be now distributed by the market rather than state planning.

As a result of these changes, a private interest now exists in the economic contracts, and privately-owned businesses have acquired the right to contract.

To facilitate the transformation of a planned economy to market economy, the E.C.L. was amended in 1993; the Company

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84. *Id.* (Quoting TAO SONG ET AL., MULTI-PERSPECTIVE THOUGHTS OF 40 ECONOMISTS ON THE SOE REFORM 91).

Law of China was also adopted in the same year.<sup>85</sup> The amended E.C.L. added peasant households and private-owned business households as parties who are allowed to enter into economic contracts.<sup>86</sup> Also, in the amended article 7 of the E.C.L., violation of Communist Party economic policy was no longer a cause leading to nullity, which signified the end of 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.<sup>87</sup>

The law regarding nullity remained unchanged, allowing the state to step in even in cases where there should be relative nullity and therefore a possibility of confirmation of the contract by the aggrieved party. This still allows the state to invade the contract autonomy.

Now that private parties have the financial incentive in contracting, as in the West, when both parties to the contract are privately owned entities, this approach to invalidity can no longer be justified. As we have seen, the contract law of Western jurisdictions is based on the principle of freedom of contract. As noted in the Introduction, it allows the victim of fraud or duress to protect his own interest by choosing whether the contract will or will not be annulled. The privately-owned companies are legal persons who have stronger incentives to protect their own interests than the state. As such, they are in a better position to make decision as to whether a contract should be annulled.

It is legitimate for the aggrieved party to have the option to exercise the right to rescission when only their interest will be affected by the decision. It is true that, in China, the majority of the economy is still government-owned, and that SOEs play a more

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

86. See Economic Contract Law art. 2 (1993).

87. See Company Law of the People's Republic of China arts. 2-3 (1993).

important role in the economy.<sup>88</sup> Nevertheless, in a market economy, contractual autonomy should extend to them 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 government authorities. Of course, the latter keep a supervising power over the management, through the authority of the State-owned Asset Supervision and Administration Commission (SASAC)<sup>89</sup>, various ministries and financial regulatory bodies. Still, they are market participants whose interests should receive only as much protection as private parties. It has been argued that, in the market economy, state-owned enterprises' interests are not equivalent to state interest.<sup>90</sup>

### III. FROM 1999 TO THE PRESENT: CONTRACTS ANNULABLE FOR FRAUD AND DURESS WHEN NO STATE INTEREST IS INVOLVED

#### A. *Contract Law in General and the Invalidity of Contract*

In response to the rapid social and economic changes, the uniform Contract Law of China was enacted to replace the three separate statutes and came into force in 1999. It is a fairly westernized statute that retains only a few of the ideological features of socialism. The new law protects the state interest in private transactions, but cautiously.

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88. 120 Centrally owned SOEs account for 62% of the Chinese GDP and the total value of their fixed assets amounts to 120% of the Chinese GDP (Data available at <http://www.sasac.gov.cn/n1180/n1566/n258203/n259490/13878095.html>). See Li-Wen Lin & Curtis J. Milhaupt, *We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 735 (2013).

89. State-owned Asset Supervision and Administration Commission (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).

90. See 隋彭生 《合同法要义》 134页 中国政法大学出版社 (2003) [SUI PENG SHENG, ESSENCE OF CONTRACT LAW 134 (Press of China Univ. of Political Science and Law 2003)].

It is the first post-1949 law that defines contract law as an area of civil law<sup>91</sup> and contracting as a voluntary act.<sup>92</sup> The law also confirms the equal status of the contracting parties and allows natural persons to enter into contracts.<sup>93</sup> For the first time, the law would deal with the manner in which offers are made and accepted.<sup>94</sup>

The tension between articles 52 and 54 of the 1999 law was pointed out in the Introduction. Article 54 provides that, as in Western jurisdictions, a party who was induced to enter a contract by fraud or duress may have it nullified or modified. Article 52 provides that a contract is “null and void” if it “is concluded through the use of fraud or coercion by one party to damage the interests of the State” (§1); if it “harms the public interest” (§4); or if it “violates the compulsory provisions of the laws and administrative regulations (§5).” To summarize the general rules, if a contract was entered into through fraud and duress, it may be annulled or modified upon the aggrieved party’s request<sup>95</sup> unless a state interest is involved; in that event the contract is void *ab initio*.<sup>96</sup> As discussed earlier, if the state were deemed to have an interest under article 52 whenever a contract was made through fraud and duress, all such contracts would be absolutely null, and article 54 would be pointless. If the state were deemed to have an interest, and a contract to be null, only if fraud and duress violated some independent law or regulation, article 52(§1) would be pointless. If neither article is pointless, there must be some circumstances in which fraud and duress violate a state interest and some in which they do not. Article 54, as we have seen, protects party autonomy in a way that article 52 does not. The question then

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91. See Contract Law art. 2.

92. See Contract Law art. 4. This is the Chinese expression of freedom of contract.

93. See *id.* at art. 2.

94. See generally, *id.* at arts.14–31.

95. See Contract Law art. 54.

96. See Contract Law art. 52 (§1).

is what protection party autonomy should receive in the present Chinese economy?

Further, the situation can be complicated by the courts' interpretations of G.P.C.L. article 58(§3), which, as mentioned in the Introduction, has rendered all civil juristic acts induced by fraud or duress absolutely null since 1986. Will the interpretation of this provision change the law on invalidity of contract formed through fraud or duress?

### *B. Party Autonomy and the Validity of Contracts*

In practice, party autonomy is gaining more and more respect. Although article 52(§1) allows a court to declare a contract formed through fraud and duress to be null when a state interest is harmed, in practice, this power is hardly ever exercised on the court's own initiative. Also, no judicial interpretation by the Supreme Court and no case accessible by research suggest what the limits of this power should be. Neither is there any existing judicial interpretation as to whether the interest of SOEs constitutes a state interest under article 52(§1).

Several positions regarding the meaning of article 52(§1) have been taken by scholars. The first position is that the interest of SOEs is not deemed to be a state interest; only fraud and duress that violate criminal law qualify as fraud and duress that damage a state interest.<sup>97</sup> The basis for this position is that Code of Criminal Law does penalize the manager of a state-owned enterprise when he or she was defrauded into entering a contract due to a neglect of duty, and the result was a heavy loss to the state.<sup>98</sup>

The second position is that a state interest includes political, economic and security interests of the state but not that of state-owned enterprises.<sup>99</sup> Only when the content and purpose of the

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97. See SUI PENG SHENG, *supra* note 90, at 134.

98. See Criminal Law of People's Republic of China art. 167.

99. See MO ZHANG, *supra* note 23, at 170.



contract induced by fraud or duress violate the public interest of the society will the contract be regarded as null and void.<sup>100</sup>

The third position is that “for the article 52(§1) to apply, the harmful effect of the contract on the innocent party whose interests represent those of the state must be so serious that no reasonable person in the position of the innocent party would elect to confirm the contract.”<sup>101</sup>

The fourth position is that:

[I]n reality, there are many circumstances where contracts are used for the purpose of misappropriating state assets and therefore infringing upon state interest. However, due to victim’s fear of being held liable or insensitivity to the loss of state assets, heavy loss of state assets might be resulted. If such contracts are not categorized as void *per se*, it is not sufficient to protect state assets.<sup>102</sup>

A consequence of the first two positions is that the “state interest” in question is only a term interchangeable with “public interest,” and that article 52(§1) does nothing more than rephrasing article 52(§4). The third and fourth positions, however, seem to provide an alternative by claiming that the state interest is that of parties who represent the state and manage the state assets. Accordingly, a state interest under article 52(§1) means the interest of state-owned enterprises other than the public in general.

To solve this puzzle, I propose a three-step analysis. The first step is to determine whether there is a state interest in a private transaction entered into by a state-owned enterprise despite the leading opinion that there is not. If there is a state interest, the second step is to determine when that interest can be harmed by act of fraud or duress in the formation of a contract. The third step is

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100. 梁慧星 《民法总论》179页 法律出版社 [HUIXING LIANG, GENERAL THEORIES OF CIVIL LAW 179 (3d ed., Law Press 2007)].

101. See BING LING, CONTRACT LAW IN CHINA 182, (Sweet & Maxwell Asia 2002).

102. 胡康生 《中华人民共和国合同法释义》79, 80页 法律出版社 (1999) [HU KANGSHENG, INTERPRETATIONS OF CHINESE CONTRACT LAW 79–80 (Law Press 1999)].

to determine when such a state interest should be considered “harmed” and under what circumstances the harm should be remedied by declaring that the contract is null. Is there state interest existing in private transactions that can be threatened by fraud and duress?

*1. Is there a State Interest in Private Transactions?*

Yes, there is a state interest in private transactions when at least one contracting party is a state-owned enterprise. There is a state interest because the state is a shareholder of a business enterprise. It used to be the case, as described earlier in this article, that the state was the sole owner of all businesses. Government ownership was the only legitimate ownership until the policy of reform and openness. Now, there is an increasing number of privately-owned enterprises, and in the stock market, there are state-owned companies listed in which less than a majority of the shares are tradable to prevent the state assets from going into the private sector. As long as there is financial investment from government, the investments in these companies constitutes state assets, which are threatened by fraud and duress.

Yet the consequence is not that the state should always intervene to protect its interests. Although the state has an interest in protecting its assets, as a market participant, the state must respect the autonomy of the parties in entering into a contract. The state interest might be protected by interfering with party autonomy. Yet, if the state nullifies every contract in which it has an interest, the new recognition of contractual autonomy and freedom of contract by 1999 Contract Law will again disappear on Chinese soil since the state will be making the decision on behalf of the contracting parties.

*2. What Interest is Article 52(§1) Protecting that can be Harmed by Fraud and Duress in Contract Formation?*

In my opinion, the only interest of the state that needs to be protected from fraud and duress in a contractual transaction is the SOEs' interest, which represents the state's pure financial interest rather than public interest.

Public interest is a universal ground for nullity of contracts. However, this interest doesn't need protection from article 52(§1). When the public interest is harmed, the contract can easily be nullified on the ground of illegality, violation of public policy or morality as suggested by laws in virtually all other jurisdictions. These grounds are also available in §2–5 of article 52. According to these subsections, a contract will be declared null, if the contract is a sham transaction that harms the public interest or violates the mandatory laws. In any event, if the state interest in question falls within the state's political, economic, or security interest—leaving aside its interest in state-owned enterprises—such an interest will be protected by article 52(§4) and (§5) rather than article 52(§1).

In addition, in the context of socialist market economy, separation of SOEs from government has been regarded as one of the core elements of SOE reform. Accordingly, the public policy should be to treat SOEs equally as a market participant and to reduce SOEs' hidden advantages as much as possible. The public policy here should be to prevent state from acting at the same time both as a referee and a player. The financial interest of the SOE therefore shall not be regarded as equivalent to a state or public interest.

Admittedly, the Criminal Code penalizes the managers of state-owned enterprises for neglect of their duties if they allow themselves to be defrauded into making contracts that result in “heavy losses of the state interest.”<sup>103</sup> It does not penalize making a contract with a state-owned enterprise by the use of fraud.

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103. See Criminal Law of the People's Republic of China art. 167.

Consequently, defrauding a state-owned enterprise is not a violation of law that will make a contract null and void under article 52(§5). There is no reason why, if the manager is penalized for bad business judgment and gross negligence, the contract itself should automatically become null. Consequently, in this context, fraud and duress do not in themselves qualify as violations of criminal law.<sup>104</sup> Moreover, contract law, being part of the civil law, is not the appropriate forum to protect the state interest from criminal conduct or conduct that violates the public interest.

On the other hand, as the sole or majority shareholder of the SOEs, the state has had a long standing financial interest in contracts made by state-owned enterprises ever since the time of the planned economy.

To understand what state interest in China can be harmed by fraud and duress, it is better to start by asking the question “why don’t Western civil laws protect the state interest from fraud and duress and make such contracts null and void?” The answer is that, if fraud or duress violates law and public policy, the contract will automatically be null and void. Nevertheless, a court will sit on its hands when the only interest harmed is the private interest of a private party. The reason is that without the existence or with very limited existence of the state-owned companies, the state presumptively has no or little interest in private transactions unless law is violated or public order is offended. In China, given the socialist features of its economic system, the state does have an ownership interest in the private contract transactions entered by state-owned enterprises. There will be no difference in each civil law jurisdiction’s treatment towards fraud or duress that violates criminal law or other statutory provisions, or when an absolute simulation or a sham transaction takes place— such contracts will be deemed null and void. The only interest China has that the

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104. See SUI PENG SHENG, *supra* note 90, at 134.

capitalist counterparts do not have is the state's pure financial interest in SOEs' interest in private transactions.

This enlarged power of the state to intervene to annul private contracts can be traced back to article 30 of 1922 Civil Code of R.S.F.S.R., which states: "A civil juristic act made for a purpose contrary to law, or in fraud of law, as well as a transaction directed to the obvious prejudice of the State, shall be invalid." Though this provision is not exactly the same as article 52(§1), they both annul contracts to protect the same interest – the financial interest of the state and SOEs. Under this Soviet Civil Code article, an otherwise legal contract that is directed to the obvious prejudice of the state is absolutely null. The Soviet case law and jurisprudence tend to suggest that the range of contracts that were deemed to be directed to the obvious prejudice of the state covers was larger than those covered by article 52(§1).

Most scholars have agreed that it was a device to guard against the undesirable growth of private business and that it was enacted in conformity with Lenin's instruction "to enlarge the interference of the State with the relations pertaining to private law and to enlarge the right of the government to annul, if necessary, private contracts."<sup>105</sup> Another scholar, T.E. Novitskaya, refers to this device as "an effective weapon in the hands of the Soviet state."<sup>106</sup> The right of the state to interfere with any contracts made in any area of civil law created a tool to avoid consequences disadvantageous for the socialist economy. In a Russian Supreme Court case, the court annulled sales contracts solely because SOEs had an interest in the objects for sale.<sup>107</sup> Such annulments were based on the "socially announced purpose of use" of the object.<sup>108</sup> In another case the high court annulled a lease and thereby interfered with a party's property right because the property right is

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105. See GSOVSKI, *supra* note 24, at 426.

106. T.E. NOVITSKAYA, GRAZHDANSKIY KODEKS R.S.F.S.R. 1922 [R.S.F.S.R. Civil Code of 1922] 86 (Moscow State Univ., Moscow 2002).

107. *Id.*

108. *Id.*

not absolute under the civil code, and the economic interest of the SOE prevailed over the property right.<sup>109</sup> It can be inferred that had the SOE been defrauded or under duress in contract formation, the Soviet courts would have annulled the contract to protect the financial interests of the SOE. Also, what makes this device more powerful than article 52(§1) is the legal sanction: when a contract is annulled under article 30, damages for unjust enrichment will be collected by the state rather than the innocent party.<sup>110</sup>

### *3. The Judicial Responses*

Chinese courts are confused as to what the state interest refers to and do not fully understand the distinction between absolute nullity and relative nullity.

My observations are based on the study of 122 cases decided under article 52.

Courts appear to be careful about declaring a contract to be absolutely null and certainly have not done so without a request from the innocent party. Courts seem to go by the checklist under article 52. They declare the contract valid if none of the circumstances under article 52 apply and no party requested that the contract be rescinded.

Also in the majority of cases decided under article 52, contracts were annulled under either article 52(§4) or article 52(§5) for violation of the public interest or of a mandatory law. It is noteworthy that in most of the cases that cited article 52(§4), the courts never cited article 52(§1) or article 52(§2) at the same time, where both provisions mention state interest. It is clear that in the opinion of many courts, the state interest in question is not the public interest but rather something else. There is a significant number of cases where courts cited article 52(§1)–(§5) as authority

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109. *Id.* at 87.

110. *See* R.S.F.S.R. Civil Code art. 147.

to nullify a contract without reference to a specific subsection or without providing any explanation.

Among these cases, only a few were decided under article 52(§1) and article 52(§2) where the state interest is identified. Is the state interest under article 52(§2) the same as the state interest under article 52(§1)? Given the logical structure of the article, most likely the state interests in both these provisions refer to the same thing – the SOEs' interest. The only difference between the two provisions is that when only one party committed the wrong in contract formation, article 52(§1) is applicable to annul the contract; when both parties collectively committed the wrong, article 52(§2) is applicable. Also the level of state interference will be upgraded when both parties are at fault: the state will annul the contract when either state interest, collective interest (meaning the rural villages' interest) or a third party's interest, is harmed.

The cases show that several Chinese courts do distinguish state interest from public interest and acknowledge that the state interest was really the SOEs' financial interest. One district court openly admitted that whenever an SOE's interest is harmed, the state interest is therefore harmed.<sup>111</sup> In this case where the court cited article 52(§2), the plaintiffs were state-owned pharmaceutical companies that entered into an agreement with two advertising firms after the two firms prevailed in the bidding process.<sup>112</sup> However, the plaintiff's employees had leaked the confidential information in the course of the bidding process to help the defendants succeed. The court, in its opinion, stated that "the employees of the two plaintiffs and two defendants committed malicious collusion and therefore harmed the two plaintiffs' interests. Given the fact that the two plaintiffs are state-owned enterprises, when their interests are harmed, the state interest is harmed." In another case decided under article 52(§1), where a

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111. *San X Pharmaceutical JSC v. Ya Advertising LLC*. 2010, Shen Luo Min Er Chu Zi No. 3X4X (citation partially omitted).

112. *Id.*

state-owned pharmaceutical company was defrauded by another pharmaceutical company, the court annulled the contract, citing article 52(§1) as the only authority, rather than using article 54.<sup>113</sup> Here, the plaintiff and appellant, a state-owned company, had sued in damages for non-performance, making no claim for dissolution. The claim was dismissed but the court declared the contract null on the basis of article 52(§1), though without explaining what the state interest was. The only possible state interest at stake here was the SOE's financial interest. It is obvious that, according to both the trial court and appellate court, the SOE didn't have the option to uphold the contract and sue in damages for non-performance even though it might be more beneficial for the state and the SOE to maintain the contract and obtain expectation damages. In a third case, it was asserted that a malicious collusion took place between the immediate past manager and legal representative of a state-owned gallery, the Gallery of Shenyang Municipality, and a pharmacy that had been a lessee leasing space within the Gallery.<sup>114</sup> It turned out that the manager kept the official stamp after he left office and produced a lease that was a counterfeit which renewed the lease for three years and lowered the rent from 1.15 million RMB to 0.8 million RMB.<sup>115</sup> The Gallery asked to have the contract annulled because "the conspiracy resulted in the loss of a state-owned enterprise."<sup>116</sup> The trial court upheld the validity of the contract based on the doctrine of apparent agency.<sup>117</sup> The appellate court sided with the Gallery and annulled the contract citing article 52(§2) because "the interest of Gallery of Shenyang Municipality is harmed."<sup>118</sup> No reasoning or

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113. Henan Middle Pharmaceutical Company v. Dong Xueling & Hubei Hualong Pharmaceutical Company 2011, 郑民二终字第1327号 [Zheng Min Er Zhong Zi No.1327].

114. Shenyang Gallery v. Shenyang Taiyuan Street Pharmacy 2005, 沈民(2)房终字第847号 [2005 Shen Min (2) Fang Zhong Zi No.847].

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*



explanation was given to identify one of the three interests listed in article 52(§2). There was no collective or third party interest involved, thus leaving only one logical explanation: the court must have been of opinion that the Gallery, as an SOE, represented the state interest. Therefore, it is fair to say that these courts are at least of the opinion that the state interest protected by article 52 is identical to the state-owned enterprise's interest.

The courts, however, are not unanimous. In another case, the court did not nullify the contract even though the state-owned hospital was defrauded in a licensing agreement for a patent and had claimed rescission of the contract based on article 52(§1).<sup>119</sup> The hospital could no longer request nullification on the basis of article 54, due to the one-year prescription. Nullity remained possible on the basis of article 52(§1) where contracts that are absolutely null are imprescriptible according to a recently published Supreme Court case.<sup>120</sup> The court's only line of reasoning was that "a state-owned enterprise's interest is not the equivalent of state interest" and therefore article 52(§1) was not applicable.<sup>121</sup> It is worth mentioning that victims of fraud or duress try to use article 52(§1) as a last resort to nullify a contract when the one-year prescriptive period for annulable contracts runs out and the victims happen to be SOEs.<sup>122</sup>

*4. When is the State Interest Harmed, and under what Circumstances shall the Article 52(§1) Power be Exercised?*

My answer to the third question is that the state or a third party can only step in to have a court declare a contract formed under fraud or duress to be null when the situation is so deleterious that

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119. Tao Zhenhai v. Liaohe Oil Field Center Hospital 2006, 沈民四知初字第65号 [2006 Shen Min Si Zhi Chu Zi No.65].

120. Guangxi BeiSheng Co. Ltd v. Beihai Weihao Real Estate Development Co. Ltd 2005, 民一终字第104号 [2005 Min Yi Zhong Zi] (Published in May, 2013).

121. See *supra* note 119.

122. See Contract Law art. 54.

the failure of the state-owned enterprise to seek restitution constitutes a neglect of duty. Such strings must be attached to prevent the state from abusing its power, and thereby harm the safety of transactions. In addition, it is not always in the state's own financial interest to rescind a contract made under fraud or duress.

If the state tried to seek annulment of every contract induced by fraud or duress on behalf of the state-owned enterprises, the state-owned enterprises would lose their autonomy as market players to make a business decision in their best interest. State-owned enterprises would then be pure government agencies rather than business entities. After all, since a government-led market economy has been established in China, private transactions are no longer mere forms in which state supplies are operated. State-owned enterprises now have independent financial status and independent management. Such intrusion, if allowed, would greatly discourage commercial transactions because people would be more concerned in making contracts where a third party or the state can step in and declare it null without their consent.

Also, as previously described, it might be in the state's economic interest to enforce a contract even though it was made by means of fraud or duress. The reasons might be that expectation damages for non-performance are greater than reliance damages that may be granted in addition to nullity, or that some market change made it beneficial to enforce such a contract. Also, the object of the contract might simply be of great subjective value to the state-owned enterprise, and therefore creates a legitimate reason for the company to enforce it regardless of fraud or duress.

Therefore, in my opinion, the enlarged state power to annul contracts can only be exercised when there is neglect in the performance of a duty and that neglect is so severe that no reasonable businessman would choose to enforce the contract after knowing of the fraud or being released from duress.

Further, state intervention can be justified by the lack of a sufficiently free and competitive market and the lack of a sufficient information indicator to evaluate the SOE performance.

We discussed the aggrieved party's incentive to act in its best interest in evaluating the financial consequences of nullification. Even though reforms have been carried out to invigorate SOEs, the state-owned enterprises are not sufficiently business-driven. The absence of effective shareholding and corporate governance results in a lack of management accountability. Managers in state-owned enterprises are more like government employees than businessmen and are short of personal incentive and financial stake in running the business. Throughout the SOE reforms around the world, it has been observed that "bureaucrats typically perform poorly in business, not because they are incompetent, but because they face contradictory goals and perverse incentives that can distract and discourage even very able and dedicated public servants."<sup>123</sup>

In China, SOE 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. Therefore, unlike privately-owned businesses, profit maximization is never the top priority of these government-employed businessmen who are tasked to carry out state policies and held accountable only to the state. 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, one may expect poor judgment when it comes to decide whether a contract should be nullified.<sup>124</sup>

Also, given the bad experience China had had during the economic reform in giving SOE managers too much autonomy and

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123. See WORLD BANK, *supra* note 71, at 3.

124. 浙江省金华县人民法院 (1992) 白民初字第57号 [Zhe Bai Min Chu Zi No. 57 (1992)]

incentive<sup>125</sup> and the incentive incompatibility that the reform fails to cure with both the policy induced burden and absence of a competitive market, this situation is unlikely to improve in the foreseeable future. Despite the introduction of a market economy, the state, as the owner of the SOEs, has its own policy agenda that needs to be carried out by SOEs, which is often incompatible with normal business incentives. For example, SOEs often have to carry out policy burdens such as the “policy-induced over-staffing” in order to assist the state in “resettling the redundant workers”.<sup>126</sup> Also, as the main forces in pursuing the state economic objectives, SOEs still don’t have the complete autonomy in choosing their production direction.<sup>127</sup> Price distortion still exists to serve the state development strategies.<sup>128</sup> Unlike in the West, profit alone usually does not accurately reflect the efficiency and diligence of the management. It is possible that a poorly managed enterprise can still generate significant profits due to the lack of competition and superficial entry barriers created by government. Under such circumstances, if the state totally keeps its hands off SOE management decision making, it is possible for the manager to

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125. Jian Chen, in his book *Corporate Governance in China*, described one of the lessons:

Contract responsibility systems were introduced in most large and medium-sized state industrial enterprises during 1986–1997. The system was officially intended to place government ownership at arm’s length to enterprise management, so allowing more decision making space (business autonomy) to the latter. In the contract, the firm hands over an agreed amount of annual profit and tax for which they have contracted. It was permitted to retain a proportion of any surplus it achieved above the contract level. Also, the firm guaranteed to invest to increase asset value and to develop technology by an agreed amount, using retained profit during the contract period. But substantial collusion soon emerged between the directors, and the heads of the supervising government departments, leading to widespread corruption. The directors found that it was easier or quicker to reward themselves by transferring the firm’s assets to their own firms. The lesson was that it was not feasible to relinquish control to the firm’s managers in attempt to improve performance.

See JIAN CHEN, *CORPORATE GOVERNANCE IN CHINA* 38–39 (Routledge 2009).

126. See JUSTIN YIFU LIN ET AL., *supra* note 15, at 114.

127. See *id.* at 119–120.

128. See *id.* at 145.

neglect the management duty to effectively protect state-owned assets and the SOE's financial interest without being noticed by the state, if the state, as the majority shareholder, only looks at the usual information indicators as in the West.

These endogenous features inherent in Chinese economy warrant the state's supervisory role over the SOEs. In response to the incentive incompatibility, information asymmetry, and liability disproportionality discussed above, it is legitimate for the state to nullify otherwise annulable contracts when affording the SOE management the option to confirm a contract that would harm the state's interest in the SOE. Nevertheless, a court cannot rescind an annulable contract on its own initiative when neither party is an SOE. If both parties are private companies, then no such state interest will be involved. The state should not intervene, no matter how serious the consequence of fraud or duress is, and how big a financial loss the innocent party suffers.

Also, the state should not be able to rescind an annulable contract where the only aggrieved party is an SOE but there is a reasonable business choice not to rescind it. This may be in order to benefit from a market change or to obtain greater damages, or because the contract has a reasonable subjective value to the aggrieved party.

### *C. Further Confusions Caused by Article 58(§3) of the G.P.C.L.*

As mentioned above, G.P.C.L. article 58(§3) adds to the complexity of the puzzle this article tries to resolve.

Though the G.P.C.L. assume their status as the highest law in the realm of civil law, as a general law, it is trumped by special laws such as contract law statutes, should any conflict exist. The GPLC govern civil juristic acts, of which contracts are a category. Every time a contract is induced by fraud or duress, a potential conflict between the Contract Law and the G.P.C.L. arises. Presumably, this outdated law should either be no longer

applicable or only applicable to civil juristic acts other than contract, in application of the civilian principle that special rules take precedence over general rules (*specialia generalibus derogant*). This would keep article 58(§3) away from further confusing the conflict between article 52 and article 54 of the Contract Law. However, an examination of 35 cases decided under article 58 in the past 23 years reveals a different story. It appears that when an SOE is harmed by a civil juristic act induced by fraud or duress, article 58(§3) merely extends the article 52(§1) protection of SOEs' financial interest afforded to the civil juristic acts by imposing the absolute nullity of civil juristic acts when induced by fraud or duress. Also, a court might use article 58(§3) to enlarge its contract nullification power and infringe the autonomy established by article 54 of the Contract Law, by considering the contract simply as a civil juristic act rather than characterizing it as a contract.

For contracts entered into between 1986 and 1999, when nullifying economic contracts formed under fraud or duress, courts usually cited both G.P.C.L. article 58 and E.C.L. article 7.<sup>129</sup> This was probably because contracting was deemed both a civil juristic act and an economic contract. When nullifying contracts between individuals where the contracts did not fall within the regime of the E.C.L., courts only cited G.P.C.L. article 58.<sup>130</sup> In a case decided in 1992, a sale of an apartment between two individuals was nullified because of a fraudulent misrepresentation by the defendant.<sup>131</sup> The act of sale was deemed a civil juristic act rather than a contract and therefore was annulled under G.P.C.L. article 58(§3) rather than under the special contract law. The court did not explain why this sale was not a contract. Most probably, because only juristic persons or business entities were allowed to enter into

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129. See (1992) 渝经上字第377号 [Yu Jing Shang Zi No.377 (1992)].

130. This is contrary to the traditional view that contracts between individuals were not regulated before 1999.

131. 浙江省金华县人民法院 (1992) 白民初字第57号 [Zhe Bai Min Chu Zi No. 57 (1992)].

economic contracts and because the sale did not comply with rigid form requirements under the E.C.L.<sup>132</sup>, the E.C.L. was not applicable to the case.

For contracts entered into from 1999 to present, in theory, courts are supposed to apply article 58 (§3) to nullify civil juristic acts that are not regarded as contracts.<sup>133</sup> In such cases, these juristic acts induced by fraud or duress are absolutely null, and therefore can be nullified on the court's own initiative. For example, in a 2005 Supreme Court case, a company in the business of international trade deceived a state-owned bank into issuing letters of credit through a series of misrepresentations when applying for the letters.<sup>134</sup> The court held that the issuance of such letters of credits was null because they were civil juristic acts that fall within the scope of article 58(§3).<sup>135</sup> Article 58(§3) is used as an extension of the article 52(1) power into the state-owned bank's issuance of letters of credit.

Also, in several private loan disputes cases, courts unanimously treated the signing of an informal acknowledgement of debts ("IOU") under the threat of physical violence<sup>136</sup> and a payment by the wife of the alleged debt of the husband when the wife was defrauded by a falsified IOU<sup>137</sup> as absolutely null juristic acts. These annulments were based solely on article 58(§3).

However, courts sometimes use article 58(§3) as a vehicle to annul contracts for fraud or duress, without mentioning article 52

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132. *For example*, under the E.C.L. art. 3, an economic contract should be in writing. Article 12 lists a series of main provisions that should be included in an economic contract.

133. *For example*, when a person made a will under duress, to nullify the will, the court has to apply art. 58(§3) of the G.P.C.L. rather than art. 54 of the Contract Law.

134. *See* (2005) 民四终字第21号 [Min Si Zhong Zi No.21(2005)].

135. *Id.* In the West, a letter of credit is regarded as a contract. However, in China, courts are not certain whether the letter shall be defined as a contract. In this case, the court seemed to be convinced that the letter of credit was a civil juristic act that was not a contract.

136. *See* (2009) 浙台商终字第98号 [Zhe Tai Shang Zhong Zi No.98 (2009)].

137. *See* (2008) 豫驻民三终字第417号 [Yu Zhu Min San No.417 (2005)].

or article 54 of the Contract Law, thus preferring the general law to the special law. This preference is generally a distinction without a difference since the victim usually requested the court to nullify the transaction anyway. Nevertheless, sometimes courts tend to nullify contracts on their own initiative when the victim of fraud or duress might in theory choose to perform the contract regardless of relative nullity.

In a case decided in 2009, the plaintiff filed suit to have the court annul a settlement agreement signed by him under duress.<sup>138</sup> In this case, the plaintiff and defendant were fathers of a newly-wed couple who were having disputes over each other's share of the wedding expenses.<sup>139</sup> The defendant brought over 40 relatives and hooligans to the plaintiff's house. The group not only beat the plaintiff but also forced him to sign a settlement agreement. Without addressing the possibility that this agreement may be considered a contract, the court treated it as an absolutely null civil juristic act, solely based on the application of article 58(§3).<sup>140</sup>

#### IV. CONCLUSION

In contrast with Western civil law systems in which contract law theories are based on freedom of contract and the expression of the will, the post-1949 Chinese contract law is based on a system in which government ownership of the economy dominates and the market is not yet free and competitive. Upon China's adoption of a market economy, the role of contract has been slowly and reluctantly moving from public economic law, which emphasizes state regulatory control, to private civil law, which requires contractual autonomy and more limited state interference. The SOE reform that has allowed SOEs more autonomy, but has not yet provided the solution to cure the incentive incompatibility, information asymmetry, and liability disproportionality between

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138. See (2009)甘民初字第2902号 [Gan Min Chu Zi No. 2902 (2009)].

139. *Id.*

140. *Id.*



the state and SOEs. Under these circumstances, freedom of contract, though adopted by the Chinese Contract Law, will be abused by SOEs at the expense of the state if made applicable to them without additional strings. The interference with freedom of contract, as exemplified by Contract Law article 52(§1), is a reasonable solution to prevent the abuse. Nevertheless, such a state intrusion must be restricted and narrowly tailored to permit the rescission of contracts only when rescission was not sought due to a neglect of a duty by those in charge of state-owned enterprises.

Despite my arguments, it remains uncertain, as we have seen from the various cases, how the Chinese courts interpret this state interest in practice. Foreign corporations, when conducting business in China and contracting with Chinese state-owned enterprises, should know that the validity of their contracts may depend on such an extensive state power when state interest is at stake. The scope of this power might be as narrow as this article proposes: it might extend to the state-owned enterprises' interest under extreme circumstances. Yet, it might also be broadly applied to protect SOEs' financial interests under ordinary circumstances and SOEs might not be afforded the option to keep the contract when it was induced by fraud or duress. Another possibility is that article 52(§1) will be applied to protect other state interests. In that event, however, article 52(§1) will merely be a paraphrase of the protection of public interest under article 52(§4), as in all the Western legal systems in which violation of public order is a ground for absolute nullity of contract.