

The influence of the United Nations Convention on Contracts for the International Sale of Goods on the Chinese Contract Law: damages for breach of contract

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List of abbreviations

BGB - *Bürgerliches Gesetzbuch*, German Civil Code

CCL – Chinese Contract Law

CCP - Chinese Communist Party

CIETAC - China International Economic and Trade Arbitration Commission

CISG - United Nations Convention on Contracts for the International Sale of Goods

ECL – Economic Contract Law

FECL – Foreign Economic Contract Law

GPCL – General Principles of Civil Law

L/C – Letter of credit

MOFTEC - Ministry of Foreign Trade and Economic Cooperation

NPC - National People's Congress

PECL - Principle of European Contract Law

PRC - People's Republic of China

TCL - Technology Contract Law

ULIS - Uniform Law for the International Sales of Goods

ULFIS - Uniform Law on the Formation of Contracts for the International Sale of Goods

UNCITRAL - United Nations Commission on International Trade Law

UNIDROIT - International Institute for the Unification of Private Law

UPICC - UNIDROIT Principles of International Commercial Contracts

Introduction

The United Nations Convention on Contracts for the International Sale of Goods (CISG) is one of the most influential international conventions dealing with civil law and for that reason it is even referred to as the *lingua franca* of international trade¹. Its success could be measured by the number of Member States, which is now counting 76 countries² and by the impact which it has on domestic law of various countries. The Convention facilitates the process of harmonization of law in two dimensions: through its ratification and through transplantation of its provision and principles into domestic law. There is an important distinction between those two processes. No provisions on mechanism for amendment of the CISG are included into its text, so it is a very inflexible instrument. On the other hand, amendment of domestic law, which could be inspired by the CISG, is far easier to introduce. Harmonization of law in those two aspects is occurring at a high pace now, which is connected with globalization processes, rising global trade volume and vivid exchange of goods, technologies and ideas. Well-grounded is the argument that:

There has never been a better time to be an international commercial law scholar. After decades of being held hostage to state-centered ideas, international commercial law has finally broken through to become more solution oriented³.

One of the most pragmatist and “solution oriented” countries in the world is China. It has taken this approach from the very beginning of the Reform and Opening-up process in 1978. The process of introducing legal concepts from the CISG and *lex mercatoria* acts is facilitated due to the fact that China did not have a tradition of statutory civil law and during the Mao Zedong reign the country suffered from the legal nihilism. The civil law had no historical ballast to deal with and could directly refer to most sophisticated legal acts available. Therefore, the very first civil law legal acts introduced after 1978 were modeled mainly after the CISG.

1 H. Sono, *Contract Law Harmonization and Non-contracting States: The Case of The CISG*, 2007, p.1. www.uncitral.org/pdf/english/congress/Sono_hiroo.pdf (access: 7.11.10)

2 http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html (access: 5.11.10)

3 S. Gopalan, New Trends in the Making of International Commercial Law, 23 *Journal of Law and Commerce* (2004) p. 117.

Nevertheless, despite the significance of trade with China and its growing influence on the world market, businessmen and lawyers tend to distrust the Chinese legal system. They rather rely on international conventions such as the CISG, of which China is a Member State from the day it became effective on January 1, 1988. This potentially diminishes the need to become acquainted with Chinese contract law with regard to contracts for international sale of goods. However, it may be necessary for at least four reasons. Firstly, the scope of application of the CISG is limited only to contracts for the international sale of goods. Secondly, it does not even govern all aspects of a contract of sale, e.g. validity of the contract or product liability for death and personal injury (art. 4, 5 CISG). Thirdly, art. 6 CISG leaves the opportunity to contract out the CISG and Chinese businessmen tend to do so and chose their own domestic law instead. Last but not least, under Chinese law, in certain situations the application of Chinese law is mandatory, e.g. for Chinese-Foreign Equity Joint Venture Enterprise Contract or a Chinese–Foreign Cooperative Joint Venture Contract, Chinese law applies⁴.

Fortunately, as mentioned before Chinese Law was in significant extent modeled after the CISG. Nevertheless, some differences between Chinese domestic law and the CISG still remain. This work would focus on the law of damages, because there are significant disparities between the CISG and the Contract Law of the People's Republic of China (further referred to as the Chinese Contract Law – CCL), mainly as for the kinds of loss recognized, types of damages awarded and the concept of breach of contract. Moreover, damages are in China the most often sought remedy for a breach.

In the first chapter of this work an outline of history of the Convention would be presented, because having knowledge of the drafting process and the early stages of the CISG is crucial to comprehend how it operates now and how successful it is compared to other similar conventions. The second chapter focuses on the Chinese law history and tradition and gives and background for understanding the modern Chinese law. The next chapter outlines the position of the CISG in Chinese legal system, reservation to the CISG and its general influence on early steps of modernization of Chinese law. The fourth chapter

⁴ N. Kornet, *Contracting in China: Comparative Observations on Freedom of Contract, Contract Formation, Battle of Forms and Standard Form Contracts*, *Electronic Journal of Comparative Law*, vol. 14.1 (May 2010), p. 2.

being the core of this study provides a comprehensive comparison between the CISG and the Chinese Contract Law in regard to the law of damages. The analysis focuses on the fundamental differences in the concept of breach of contract and similarities and disparities of the regulation of methods of limiting damages such as causation, foreseeability, mitigation and moreover standards of proving loss and calculation of damages. The law of contracts provides only the legal framework for contracting parties. How those provisions are understood by parties and implemented by courts and arbitration bodies depends on the society, the cultural and the legal heritage within which they operate. To give some basic insight into this matter a distinction between law in books and law in action should be made. As Professor Chen writes: ‘Having laws is one thing; having them properly implemented is another’⁵. Therefore, the chapter 5 would deal with application of the CISG in China.

Due to the fact that 1994 UNIDROIT Principles of International Commercial Contracts (UPICC) and 1999 Principle of European Contract Law (PECL) may be used to interpret CISG⁶, they would also be mentioned as reference in several issues.

⁵ J. Chen, *Chinese Law: Context and Transformation*, Leiden 2008, p. 653.

⁶ R. Goode, H. Kronke, E. McKendrick, J. Wool, *Transnational Commercial Law* (2004), p. 40.

1. The CISG history

The CISG history could be traced back to 1920's. On September 3, 1926 the International Institute for the Unification of Private Law (UNIDROIT) was founded in Rome and inaugurated two year later on May 30, 1928. The person who contributed to the development of early international law of sales the most was indisputably Ernst Rabel (1874-1955), a Professor of Law at the Universities of Leipzig, Basel, Kiel, Göttingen, Munich, Berlin and after emigration to United States – also Law Schools of Ann Arbor and Harvard⁷. On February 21, 1929 he submitted his preliminary report on the chances of unification of sales law⁸. He thought that there is a possibility of reaching this goal and due to his efforts on April 29, 1930, a committee consisting of representatives from different legal systems was founded⁹. The first draft of a uniform sales law was published in 1935. One year later, Rabel published *Das Rechts des Warenkaufs*, work that made a milestone in development of scholarly work on uniform sales law. In his book he compared the features of contracts of sale regulation from different legal system, and therefore laid the ground for their mutual understanding and harmonization. The works on convention unifying trade law were stopped by World War II and resumed not until January 1951 when a diplomatic conference on the unification of sales law was held in Hague. The commission established on this conference prepared draft on substantive sales law in 1956. Similar draft was prepared by the UNIDROIT in 1958. Those drafts were deeply discussed by governments and academicians. As a result of this discussion a consensus was reached and in 1964 two major conventions were presented: Uniform Law for the International Sales of Goods (ULIS) and Uniform Law on the Formation of Contracts for the International Sale of Goods (ULFIS). Both conventions entered into force in 1972, but were joined only by nine countries and occurred to be a major failure.

United Nations Commission on International Trade Law (UNCITRAL) - another important body, which deals with international commerce law, was established on December

⁷ <http://www.globalsaleslaw.org/index.cfm?pageID=649> (access: 4.04.2011)

⁸ P. Huber, A. Mullis, *The CISG: A new textbook for students and practitioners*, Munich 2007, p. 2.

⁹ I. Schwenzer, P. Hachem, *The CISG- Succeses and Pitfalls*, 57 *American Journal of Comparative Law* (Spring 2009), p. 459.

17, 1966 and continued work on the unification of sales law from 1968 onwards. It mandates to “further the progressive harmonization and unification of the law of international trade”¹⁰. The main success of UNCITRAL was incorporating both procedural and substantive aspects of international sales law into one document and achieving finer balance between developed and developing nations; a lack of which was an obstacle for the development of Hague Conventions. The works on first draft of a uniform law were finalized in January 1976. Between March 10 and April 5, 1980, delegates from sixty-two nations discussed the convention, which would be known as the United Nations Convention on Contracts for the International Sale of Goods. At the end of the conference, forty-two countries voted in favor of it¹¹. On December 11, 1986, after ratification by United States of America, China and Italy, the necessary number of ten ratification prescribed by art. 99 CISG was reached and the Convention entered into force on January 1, 1988.

The layout of the CISG differs from the Hague Conventions, because it covers both formation and substantive rules. The structure is divided into four parts:

Part I – Sphere of Application and General Provisions;

Part II – Formation of the Contract;

Part III – Sale of Goods (Substantive Rules for the Sale of Goods);

Part IV – Final Clauses.

The main ideals that the CISG was based on are: uniformity, flexibility and filtration¹².

Uniformity: The provisions of the Convention should be applied in the same way by every court and courts should not revert to domestic law without ascertaining whether general principles of the CISG or private international law apply. This ideal is hard to reach, because judges have educational and practical background that is specific for the country, where they were educated. Therefore, they may tend to interpret the CISG provisions from the standpoint of their country own law.

10 P. Schlechtriem, P. Butler, *UN Law on International Sales: The UN Convention on the International Sales of Goods*, Berlin 2009, p. 1-2.

11 I. Schwenzer, P. Hachem, *The CISG- Successes and Pitfalls*, p. 460.

12 Apart from those three authors mention also „practicability”. In my opinion this feature is obvious and need not to be elaborated.

P. Schlechtriem, P. Butler, *op. cit.* p. 6.

The idea of uniform law is not a new one for it extends back to 16th -17th century *lex mercatoria*¹³. In that time Lord Mansfield stated:

mercantile law (...) is the same over the world. For from the same premises, the sound conclusions of reason and justice must universally be the same¹⁴.

There is still a long and winding road to go through, before the ideal of Mansfield would be truly achieved. Nevertheless, the parties to the contracts themselves try to reach a common ground and therefore uniform law would be in line with their needs. Moreover, employing consistent approach could be effective if knowledge about the CISG among judges would develop. Now, mainly due to publication of many scholarly works and cases this goal is almost reached. This topic is highly relevant to the whole work and therefore more remarks would be made in the chapter 5.2 on problems with the CISG application.

Flexibility: In the CISG there are still some “old relicts”, as Professor Honnold call them¹⁵. For example, art. 13 CISG mentions telegram and telex as forms of “writing”, but the whole Convention is silent as for electronic means of communication. Some concern is also raised as to art. 19 CISG regulating “battle of forms”, which is quite inadequate for the modern trade practice. Nevertheless, every provision (apart from obligation of trading in good faith) could be withdrawn by the parties. As a whole, the regulation and general principles are still very up to date. Convention's provisions are also general enough to adapt to the changes in business environment.

Filtration: Professor Schlechtriem states that principles of the CISG must seep into domestic law, especially when the domestic regulation is silent on certain matters regulated by the CISG¹⁶. The Convention indirectly influences changes in domestic law as it was during the reform of German Civil Code and Scandinavian and Netherlands law. Courts also tend to use the CISG and other model law instruments when interpreting domestic contracts, which have some gaps.

13 *Ibidem*, p. 7.

14 L. DiMatteo, L. Dhooge, S. Greene, V. Maurer, M. Pagnattaro, *International Sale Law: Critical Analysis of CISG Jurisprudence*, Cambridge 2005, p. 1.

15 P. Schlechtriem, P. Butler, *op. cit.*, p. 7.

16 *Ibidem*, p. 7.

Now, the CISG has gained worldwide acceptance. It has 76 member states and within that nine out of ten leading trade nations¹⁷. About seventy to eighty percent of all international transaction is potentially governed by the CISG¹⁸. On the website: <http://www.cisg.law.pace.edu/>, which serves as a main reference for academicians and practitioners interested in the CISG, there are approximately 2500 court decisions and arbitral awards and a significant number of scholarly materials published. Moreover, the annual Willem C. Vis International Commercial Arbitration Moot, which is basing on the CISG, is getting more and more popular. This year participants from 262 universities from 66 countries would compete¹⁹. There is even a Willem C. Vis (East) International Commercial Arbitration Moot, which is held in Hong Kong. A history of CISG is indeed a success story and still more and more countries decide to ratify it (lately, in 2008 it was ratified by Japan, most important among the new member states) and moreover its impact on drafting processes of domestic law is gaining significance.

17 http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html (access: 4.04.11)

18 I. Schwenzer, P. Hachem, *The CISG- Successes and Pitfalls*, p. 457.

19 <http://www.cisgmoot.org/> (access: 5.04.11)

2. Overview of the Chinese traditional and modern law

The concept of law is strongly embodied in Chinese culture, though it had different features than in the Western countries. Chinese traditional law was concerned with all acts of moral or ritual impropriety or criminal conduct, which seemed to be a violation of harmony (*he*), one of the most appreciated values in Chinese society, if not the most. A disturbance of the social order meant, according to Chinese world-view, violation of cosmic order and the purpose of law was to restore it²⁰. Therefore, law operated not between citizens themselves, but vertically, between citizens and state and its representatives, whose role was to maintain the harmony. The law was an instrument by which rulers controlled people. There was no government by law (*fazhi*), but government by man (*renzhi*)²¹. This is why law had mainly penal and administrative character. Another feature of Chinese traditional law was its naturalization – death sentences could be carried out only in autumn and winter, the season of decay, and never in spring and summer²².

The oldest relicts of law include *inter alia* written forms of agreements, known as *qiyue*, from West Zhou (1046-771 BCE)²³. However, an important discussion on law started not earlier than in 6th century BCE. In 513 BCE Fan Xuanzi proclaimed law engraved on tripod and was criticized by Confucius, because law that would apply to everybody irrespectively infringe the inequality between gentlemen (*junzi*) and simple people (*xiaoren*). In 501 BCE Teng Si, another person, who tried to introduce statutory law, the so called “bamboo law”, was sentenced to death²⁴.

The concept of law was placed among the most important elements of ruling the country not earlier than in 4th century BCE, when Shang Yang, the first of Legalist school of thought (*fajia*) served as statesmen in State of Qin, which later unified China and in 221 BCE established the first Chinese imperial dynasty. Shang Yang introduced to Qin the Book

20 D. Bodde, C. Morris, *Law in Imperial China*, Pennsylvania 1973, p. 4.

21 F. Michael, *The Role of Law in Traditional, Nationalist and Communist China*, *The China Quarterly*, No. 9 (Jan. - Mar., 1962), p. 126.

22 D. Bodde, C. Morris, *op. cit.*, p. 45.

23 J. Chen, *op. cit.*, p. 443.

24 F. Bykow, *Powstanie chińskiej myśli politycznej i filozoficznej* [The origins of Chinese political and philosophical thought], Warszawa 1978, p. 104.

of Law (*fajing*), written earlier by Li Kui. A quirk of fate was that he was later sentenced to death under the provisions of this very code. Nevertheless, he was one of the main contributors to Legalists philosophy, which along with Confucianism (*rujia*) affected the concept of law and style of ruling country the most.

The main feature of Chinese traditional law is conflict between ritual (*li*) and statutory law (*fa*). Those two values are important even in the modern China and the conflict between them, comparable to relationship between statutory law and natural law in Western countries, is still valid.

Ritual regulated many spheres of living. It was a kind of model behavior and a way of doing one's social functions properly. Nevertheless, the person who know ritual and tradition, but has no virtue (*de*) is like a lady, who is using a lot of make up, but do not have beautiful eyes and do not know how to smile²⁵.

According to the Confucian view the nature of man was good. Men should be led by their virtue. If the ruler is virtuous, the people he governs would be the same.

The virtue of gentlemen is like the wind; the virtue of petty people is like the grass.

When the wind blows over the grass, surely it will bend²⁶.

Broadly speaking, ideal Confucian society consisted of virtuous people, who act according to ritual. This point of view was quite elitist and applied only to certain social group.

On the contrary, Legalists believed that the nature of man is bad and it should be controlled by state using various means, mainly law. They emphasized harsh laws and its punitive functions. The base of governance is the authority, which is exercised by punishments and rewards. The moral character of ruler is of no matter.

The main wedge issue between those schools was raising the law to universality²⁷. According to Confucianists law is not as important as ritual and virtuousness. Nevertheless, it can be used to govern petty people, who do not know ritual and do not understand refined Chinese culture. Legalists believed that law should be applied universally, both to nobles and common people.

25 Y. Feng, *A history of chinese philosophy, vol. I*, trans. Derk Bodde, Princeton 1983, s. 66.

26 trans. B. Watson, *The Analects of Confucius*, Columbia 2007, p. 83.

27 E. Balazs, *Chinese civilization and bureaucracy*, Yale 1972 p. XIV-XV.

The features of those two schools of thought could be seen in modern China. It tries to show its cultural Confucian heritage, based on harmony, but when the situation gets worse it could use the iron fist of Legalism.

Those two schools had impact on drafting various legal codes of Imperial China Dynasties (221 BCE-1911 CE). Among them the most important was the Tang Code from 624 CE. Its influence on future development of Chinese law is comparable to impact that *Corpus Iuris Civilis* had on Western law. Nevertheless, in its essence the Tang Code was mainly criminal and administrative act. The quality of this code is so high that it could be compared to major penal German codification from XVI century – *Constitutio Criminalis Carolina*. The legal codes of following dynasties till the last dynasty – the Qing, generally were modeled after the Tang Code, however gaining more sophisticated approach and broadening their scope of regulation. Nevertheless, the civil law was not codified or even collected in single act till last year of the Qing dynasty reign.

At the beginning of 20th century, in 1902 the Law Codification Commission was set up and it prepared draft codes on civil law, criminal law, law of civil and criminal procedure, bankruptcy law and others. Nevertheless, those acts remained on paper²⁸. Few years later, as an effect of emerging of Xinhai Revolution (1911) the last Chinese Emperor Puyi abdicated on February 12, 1912. Those events opened the modern history of China.

The most important changes to China's legal system were introduced firstly by Chinese Nationalist party (*Guomindang*). The five parts of Civil Code were promulgated between spring of 1929 and December 1930. This was a first comprehensive Civil Code enacted in China. It laid foundation for building the whole system of law, with branches similar to those in Western Countries. Moreover, the Company laws, Banking laws and other commercial laws were also promulgated. A law of Civil Procedure and new Criminal Code were enacted in 1935. In a short period of time over hundred of new legal acts were promulgated²⁹. The drafts were almost entirely modeled after German Civil Code (*Bürgerliches Gesetzbuch*, 1896) in their first three books (General Part, Law of Obligations, Property Law), but not the last two (Family Law, Law of Succession)³⁰. It also

28 F. Michael, *op. cit.*, p. 133.

29 *Ibidem*, p. 133-134.

30 P. C. Huang, *Code, custom, and legal practice in China: the Qing and the Republic compared*, Stanford 2001, p. 62.

took as the reference the Civil Code of Japan from 1896 (influenced by the first draft of BGB) and Code Civil from 1804.

The main feature of Guomindang reforms was adoption of capitalist system, which was reflected in promulgated laws, e.g. legal title to property carried by individual, not each family; broad regulation of contracts that could be entered freely by individuals³¹.

When on 1st October 1949 Mao Zedong proclaimed the People's Republic of China (PRC), a new approach toward law was introduced, which had no close connection either with Chinese traditional law or system based on Western law introduced by Guomindang. The law was used as an instrument of policy, a tool to intimidate, and a mean to introduce Communist programs³². Communists also eradicated the laws previously enacted. This process began in January 1949 when Chinese Communist Party (CCP) abolished the constitution adopted under Guomindang Party. In February 1949 CCP issued Directives on the Abolishment of the Code of Six Laws and the Establishment of Judicial Principles in the Liberated Areas. In effect, all the laws that were effective under Guomindang were annulled. Mao wanted to build his new country on a “plain paper”:

there would be no burden bearing with a piece of plain paper, on which the newest and most beautiful words could be written and the newest and most beautiful pictures could be drawn³³.

Mao turned to peasantry and youth who were “poor and blank” and against intellectuals and creations of their culture, e.g. law³⁴. In 1956 and 1957, when Mao started Hundred Flower Movement, which main slogan was: "Let a hundred flowers bloom; let a hundred schools of thought contend" (*baihua qifang, baijia zhengming*). The goal was to encourage the exchange of ideas about state policy. Naïve persons, who in response to encouragements to reveal their opinions criticized government, were later persecuted. Some of them spoke up in favor of restoring legal concepts of Western tradition, e.g. establishing right to defense. Party called those views “rightists” and “absurd”. Party was “always right” and therefore

31 *Ibidem*, p. 57.

32 F. Michael, *op. cit.*, p. 134.

33 M. Meisner, *Mao Zedong: A Political and Intellectual Portrait*, Cambridge 2007, p. 149.

34 *Ibidem*, p. 149.

accusation itself indicated guilt. There could be no place for defense lawyer³⁵. This system operated without any written law, nor customary law, nor even general principles, precedent, court decisions. Law was only a weapon of the Party and was applied arbitrarily. It provided almost no legal norms that could be followed.

Nevertheless, there were very few legal acts regulating civil law. The first law of contracts in PRC, the Provisional Measures concerning the Making of Contracts among Governmental Institutions, State-owned Enterprises and Cooperatives was enacted in 1950. The purpose of this law described in art. 1 embodied communist values: protection of state interest, promotion of economic efficiency and guaranty of implementation of state plans³⁶.

One of the most important events in Chinese modern history that affected a legal system in tremendous way was the Cultural Revolution (*wenhuadageming*) that lasted from 1966 till 1977. It was a social movement initiated by Mao Zedong in order to remove capitalism and traditional Confucian elements from society. During that time Ministry of Justice was closed and was reestablished not earlier than in 1979. Also the vast majority of universities was shut down, because they were said to maintain capitalist order. Moreover, teachers and professors were called the “ninth stinky category” and were persecuted. Therefore, for ten years almost no lawyers attended universities nor practiced. It resulted in a serious lack of cadre for legal schools which reopened after the end of Cultural Revolution and in a lack of young people educated in law.

After death of Mao Zedong in 1976 and the downfall of Gang of Four (*Sirenbang*) led by his widow, Jiang Qing, the group of politicians connected with Deng Xiaoping took the power. They were officially chosen as China new leaders at the Third Session of the Eleventh Congress of the Communist Party in 1978. Although the name of ruling party was not changed, major changes inside the whole mechanism of governance occurred and moved it toward more pragmatic way. Two slogans of Deng Xiaoping are describing this process quite well: “to get rich is glorious”³⁷, “no matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat”³⁸. Their political and economics reforms aimed at

35 F. Michael, *op. cit.*, p. 145-146.

36 J. Chen, *Chinese Law: Context and Transformation*, Leiden 2008, p. 444.

37 O. Swartz, *Critical thought on law and reform in post-maoist China*, 8 Gonz. J. Int'l L. (2004-05).

38 F. Zakaria, *Does the future belong to China?*, Newsweek, May 9, 2005.

building capitalism by introducing Four Modernizations (*si ge xiandaihua*): of industry, agriculture, science and military defense. The period of reforms that they started and that still in progress is called “Reforms and Opening-up” (*gaige kaifang*).

Nobel Memorial Prize in Economic Science winner, prof. Ronald Coase, who specialized in socialist economy, once said:

But with all the discussion (...) about setting up 'market system' in former communist lands, one thing should be kept in mind: It cannot be done without first creating the legal system that protects the rights of all individuals to hold, buy and sell property and without corresponding legal protections for the contracts through which those transactions are conducted³⁹.

Similar idea was raised by Randall Peerenboom, author of probably the most influential book on rule of law in China - “China's Long March Toward Rule of Law”. According to him: “advocates of rule of law and neoclassical economists alike have argued that sustainable economic development requires rule of law and in particular clear and enforceable property rights”⁴⁰; “a market economy is a rule of law economy”⁴¹. Not only rule of law seems to be prerequisite of sustainable growth and economic development, but also could ensure protection of certain rights of citizens, so they would be satisfied enough not to raise political claims, e.g. to shift toward democracy. As Peerenboom stated: “Rule of law is desirable alternative (...) for political reform without democracy”⁴². On the other hand, idea of implementation the rule of law faced serious criticism in China. It was said to be Western idea that could not be transplanted. The class nature of law was emphasized and law was claimed to be a mask for oppression⁴³. It was argued that where in some Western countries rule of law was evolved gradually, in China it is implemented too fast and this rapid change may lead to confusion⁴⁴. Nevertheless, the rule of law was accepted by ruling Communist Party and was mentioned on the same Third Session of the Eleventh Congress of the Communist Party in 1978, which brought Deng Xiaoping to power. It was proclaimed that: “there must be laws to rely on; where there are laws, they must be followed; laws must

39 D. Li, *The Foreign Economic Contract Law: Cases and Analysis*, Michigan 1993, p. 3.

40 R. Peerenboom, *China's Long March Toward Rule of Law*, Cambridge 2002, p. 19.

41 *Ibidem*, p. 55.

42 *Ibidem*, p. 21.

43 *Ibidem*, p. 127.

44 *Ibidem*, p. 156.

be strictly enforced; and violation of law must be corrected (*youfa keyi, youfa bi yi, zhifa bi yan, weifa bi jiu*)⁴⁵. Having this statement in mind, Deng Xiaoping and his followers introduced significant legal changes to the PRC.

One of the first PRC civil legal acts, Economic Contract Law (ECL), was enacted on 13 December 1981 (effective 1 July 1982). The term “economic contract” (*jingji hetong*) was derived from Soviet Union, because drafters tended to model their law system on countries with similar economic system. The Western legal terms were considered improper⁴⁶. In Chinese law there is a worldwide known distinction between nominated contracts and contracts without a title. The ECL applied only to certain contracts mentioned in art. 8: contracts on purchasing and marketing, sub-contracting for construction projects, undertaking processing, goods transport, power supply and use, storage, property lease, loan, property insurance, scientific and technological cooperation and other economic contracts. The scope of this regulation was very narrow, because the ECL applied only to legal persons (*faren*). Art. 2 ECL defined economic contract as an “agreement between legal persons specifying their mutual relations, rights and obligations in order to realize certain economic aims”. In 1993 National People's Congress (NPC) amended this law and broaden its scope of application to other economic organizations, individual business house-holds (*getihu*) and farmers who signed an agricultural responsibility contract (*nongchunchengbao jinnyunhu*)⁴⁷. Still, natural persons (*ziranren*) were outside the scope of application. As for contract formation, the offer and acceptance, which is now widely used in China and also gained an overwhelming popularity in the whole world, was not recognized at that time. The ECL stressed the agreement, which was reached through bargain⁴⁸. Despite applying some modern concepts of contract law, the ECL was still tailored to the central planned economy conditions: upon this law contracts could be void, if the State plan had changed; written form of contracts was always required.

The second major civil legal act was the Foreign Economic Contract Law (FECL) adopted on 21 March 1985 (effective 1 July 1985). The FECL served several functions: it

45 *Ibidem*, p. 57.

46 F. Chen, The new era of Chinese contract law: history, development and comparative analysis, 27 Brooklyn J. Int'l L. 153 (2001), s. 159.

47 *Ibidem*, p. 159.

48 *Ibidem*, p. 161.

contained private international provisions, but also regulations on international contracts. This regulation was nevertheless very insufficient – it counted only 43 articles regulating international contracts (for example, Czechoslovakian Code of International Commerce comprised 766 articles)⁴⁹. It applied to contracts between Chinese enterprises, foreign enterprises and individuals, which have “foreign element”. Sino-foreign joint venture companies, which were very popular in 90's were treated as a Chinese legal persons. Chinese individuals were explicitly excluded. Its scope of application was so broad, that in fact it regulated all activities of foreign entities in China. The FECL was far more open than the ECL. According to its provisions parties could choose applicable law (in absence of choice of law the closest connection rule was applied); there was no state impact on validity of contracts; the formation of contract still have to be in writing; the limitation period was longer than in the ECL and counted 4 years⁵⁰. There was an important difference between the ECL and the FECL as for the damages. The ECL law of damages was strict and in order to maintain control over business entities the penalties applied were much higher than the actual damage; the punitive damages were widely used. The FECL took more liberal approach by emphasizing the compensatory function of damages⁵¹. With respect of breach of contract two kinds of it were mentioned in the FECL: non-performance and failure to fulfill the contract in accordance with stipulated terms⁵².

Another important legal act from this period was the Technology Contract Law (TCL) enacted by NPC in 1987 and implemented in 1989. The TCL did not excluded natural persons from the scope of its application, but on the other hand it applied only to Chinese parties. It classified a technology contracts into four categories: 1) technology development contracts; 2) technology transfer contracts; 3) technology consultant contracts; and 4) technology service contracts⁵³. Prior to this act all invented technology belonged to state. This change was a symptom of new emphasis on individual rights.

Apart from these three acts the General Principles of Civil Law (GPCL) were

49 S. Williams, *Foreign Economic Contract Law of the People's Republic of China*, p. 31. (journals.cambridge.org/article_S0020589300045681 – access: 2.04.11)

50 Y. Zhang, *Harmonization of contract law*, 2007, p. 4.

51 F. Chen, *op. cit.*, p. 166.

52 D. Li, *op. cit.*, p. 9.

53 F. Chen, *op. cit.*, p. 166-167.

adopted on April 12 1986 (effective January 1, 1987). They served the function of very general and abstract civil code. Art. 85 of GPCL defines contract as: “(...) an agreement whereby the parties establish, change or terminate their civil relationship. Lawfully established contracts shall be protected by law.” As for contract law the GPCL also deals with civil liability for breach of contract, contract performance and provides gap-filling regulations.

The ECL, FECL and the GPCL were the three pillars of Chinese Civil Law. Nevertheless, there occurred major problems in application of those acts leading to confusions and legal uncertainty.

To resolve this problem by unifying and revising Chinese civil law the Legislative Affairs Committee (*fangongwei*) started in 1993 the drafting work. The draft of the Major Provisions of the Contract Law was written in the same year by a small drafting group comprising Liang Huixing (CASS Law Institute), Jiang Ping (China University of Politics and Law), Wang Liming (People's University), Cui Jianyuan (Jilin University), Guo Mingrui (Yantai University), Li Fan (Supreme People's Court), He Xi (Beijing High Court), and Zhang Guangxing (editorial department of the CASS Law Institute Journal *Faxue yanjiu*)⁵⁴. In 1995 twelve academic institutions, including the Law Institute of the Chinese Academy of Social Sciences, Beijing University, the People's University, the China University of Political Science and Law, and Yantai University, joined the drafting process and started to prepare a second draft, which was issued in October 1995. On 4 September 1998 the full text of the draft was issued for public consultation and the results were received month later⁵⁵. Finally, The new Contract Law of the People's Republic of China was adopted on 15 March 1999 (coincidentally on the 'consumer rights protection day'⁵⁶) and entered into force on 1 January 2000. The Economic Contract Law 1981 and the Foreign Economic Contract Law 1985 and the Law on Technology Contracts were abolished⁵⁷.

The CCL is based on four basic principles:

54 P. B. Potter, *The Chinese Legal System: Globalization and local legal culture*, London 2001, p. 40.

55 J. Chen, *Chinese Law: Context and Transformation*, Leiden 2008, p. 448-449.

56 D. Ding, China and CISG [in: *CISG and China: Theory and Practice*] (1999), p. 33.

57 Y. Zhang, *op. cit.*, p. 4.

- a) accordance with the Constitution;
- b) basing on actual circumstances and China's existing legal system;
- c) aim to promote economic development;
- d) taking international conventions and international practices as reference⁵⁸.

The Chinese Contract Law has two parts: General Provisions and Specific Provisions, 24 chapters and 428 articles. It includes Basic Principles: Conclusion of a contract, Validity, Performance, Modification and Transfer, Termination of Rights and Duties, Liability for Breach of Contracts and Other Provisions; and Specific Provisions: Sales Contracts, Contracts for the Supply and Use of Electricity, Water, Gas and Heat, Contracts for Gifts, Contracts for Loan, Contracts for Lease, Contracts for Financial Leasing, Contracts for Work, Contracts for Construction Projects, Contracts for Carriage, Contracts for Technology, Contracts for Deposit, Contracts for Warehouse, Contracts for Mandate, Contracts for Commission, Contracts for Brokerage and Supplementary Provisions.

The CCL regards the freedom of contract (*hetong ziyou*) as a major feature of modern civil law. It is no longer using the term “economic contract”, which contained a strong connection to a centrally planned economy⁵⁹. Contract is no longer defined as an agreement between legal persons or units, but as an agreement between citizens, legal persons and other organizations of equal status, which creates, modifies, and terminates creditor's rights and obligation relationship⁶⁰. Moreover, art. 10 CCL establish for the first time freedom of form. Nevertheless, contracts have to be in accordance with good faith – *chengshi xinyong* (art. 6 CCL) and social public morality – *shehui gongde* (art. 7 CCL), which gives government officials a wide discretion in determining whether contract is lawful or not⁶¹.

Another important feature of the CCL is regulation of internet transactions. The offer made by means of electronic data becomes effective at the time of logging into system, which was specified by offeree or, if the system was not specified, at the time of logging into any computer system owned by the offeree. The CCL reflects positive attitude toward

⁵⁸ *Ibidem*, p. 3,

⁵⁹ F. Chen, *op. cit.*, p. 169.

⁶⁰ J. Chen, *op. cit.*, p. 450.

⁶¹ P. B. Potter, *op. cit.*, p. 47.

the modern development of electronic transmissions, that so far were regulated mainly by model law (e.g. 1996 - UNCITRAL Model Law on Electronic Commerce, 2001 - UNCITRAL Model Law on Electronic Signatures with Guide to Enactment, 2005 - United Nations Convention on the Use of Electronic Communications in International Contracts). Even the UCC do not regulate electronic commerce despite the fact that it is very popular in US⁶².

Under the provisions of the CCL the major way of concluding a contract is offer and acceptance. It is a significant change, because traditionally parties have concluded contract by signing an affirmation letter after negotiation⁶³. Now, the conclusion of a contract is much simpler. It should be noted that under the CCL, the common law “mail-box” rule does not apply (art. 23) – acceptance take place when communicated.

The ECL did not allow suspension of performance regardless of the other party financial situation and other factors. The CCL introduced major changes in this matter, which would be elaborated in the chapter on breach of contract. It should be noted that the right to suspend performance is one of fundamental principles of new *lex mercatoria* and finally it was introduced into Chinese domestic law too.

Nevertheless, some elements of previous law, which were tailored to state planned economy, still remain. As for provisions regarding interpretation of contracts and gap-filling regulation (art. 62 CCL), the “government mandate price” prevails over “market price”⁶⁴. If the quality had not been prescribed clearly, the state standard would apply in first place, not the common standard of specialized area of business or reasonable quality (art. 5.1.6. UPICC). Therefore, the government role in the market is still significant.

There is no doubt that enacting the CCL was a major step in Chinese civil law. It successfully introduced a framework for all contractual activities; it has eliminated the distinction between foreign-related and domestic contracts and between civil and economic contracts. It also in significant extent modernized the regulation of previous acts introducing provisions modeled after modern *lex mercatoria*⁶⁵. Now, the CCL is regulating matters that

62 F. Chen, *op. cit.*, p. 171.

63 *Ibidem*, p. 172.

64 J. Fu, *Comparison of contract interpretation between EU and China*, p.13.

65 J. Chen, *op. cit.*, p. 458.

are outside the regulation of many foreign domestic civil codes, e.g. internet transactions. The CCL is a very up-to-date and sophisticated code, that if applied correctly, would lead to improvement of Chinese legal culture and would ensure a safe environment for business conduct for Chinese and foreign parties.

Last but not least, there is an important feature of Chinese legal culture that has a tremendous impact on the way that contract are formed and performed, which is called *guanxi*. This term means network of influence, personal connections, which include mutual obligation, reciprocity, goodwill and personal affection⁶⁶. It reflects the collective view of society embodied in Chinese culture – people are not contracting individual, but each of them is a part of a business network. Chinese people will devote a significance amount of time on building that relationship, which they find more important than simple business dealings. Each contract in China is made in rather slow pace, because formation of it involves a lot of dinners, meeting and getting to know each other. When the Chinese counterpart gains trust on the other part, then contractual negotiation may continue.

There are three levels of *guanxi*: the first, highest is for family members. Non-family members who have a strong connection based on trust occupy the next level. The last, third level is for strangers, who are not known and therefore not trusted⁶⁷. The Chinese are eager to build relationship with Westerners so they could move to the second level, but this require cooperation and time.

Guanxi is essential for business success in China. Nevertheless, Western businessmen regard it to be no more than corruption, because it usually involves giving small gifts, but this is a misleading approach to *guanxi* for it is rather based on trust, shared experiences and honor. Every gift must be repaid, but not necessarily with a thing or favor of the same value.

Guanxi influences the way contracts are perceived. For Westerners a contract is a final conclusion of a business deal, which is normally preceded by negotiations. After the contract is formed parties just have to perform their obligations and generally act in good will not to harm other party interest. From the point of view of Chinese legal culture, the

⁶⁶ P. Pattison, D. Herren, The Mountains are high and the emperor is far away: sanctity of contract in China, *American Business Law Journal*, Volume 40, Issue 3, March 2003.

<<http://www.lawnet.lk/docs/articles/international/HTML/BA19.html>> (access 10.04.11)

⁶⁷ *Ibidem*, <<http://www.lawnet.lk/docs/articles/international/HTML/BA19.html>> (access 10.04.11).

contract is just a rather insignificant moment within a relationship that is being built, it anticipates rather than defines relationship⁶⁸. Relationship may evolve and situation may change and therefore the Chinese businessmen do not tend to stick to the contract and are often eager to change its terms, which may be negatively perceived by Western parties, that treat contract as a final agreement, almost a sanctity. It should be kept in mind that:

The core concepts of the classical Chinese philosophy revolve around relationships and situational specificity, not on task accomplishment, as is emphasized in most Western cultures.⁶⁹

Since the personal relationship is being emphasized, the Chinese tend to look upon law negatively, especially on the courts disputes, which are signs of a violated harmony. People who trust and honor themselves do not go to courts, but manage to solve the conflicting matters and continue or not *guanxi*. Adjudication is seen as an 'unseemly emphasis on private interest'⁷⁰. Moreover, the open conflict may lead to losing of face (*mianzi*), another core Chinese concept, which is close to the Western meaning of the word "reputation". In some cases, the Chinese may agree on unfavorable contracts or accept the loss without any damages awarded just to save *mianzi*.

China's long and rich legal history influences approach to contracts, which in many aspects significantly differs from the Western experiences. Understanding of it may facilitate contracting with Chinese parties and getting insight into their law not only on textual level, which as it would be proved, seem very similar to the Western legal standards, but also on the way this law is applied, which is strongly influenced by the history and culture, which should be understood, because: "With the advent of a truly globalized world, it is not only markets but entire cultures that are coming into contact."⁷¹

68 N. Kornet, *op. cit.*, p. 6.

69 P. Pattison, D. Herren, *op. cit.*, <<http://www.lawnet.lk/docs/articles/international/HTML/BA19.html>> (access 10.04.11).

70 P. McConaughay, Rethinking the Role of Law and Contracts in East-West Commercial Relationships, *Virginia Journal of International Law*, Vol. 41, 2000, *supra* note 3, p. 450.

71 M. Chen, *Inside Chinese Business: a guide for managers worldwide*, 2001, p. xiii.

3. CISG and China

3.1. General remarks on the CISG influence on Chinese contract law

The People's Republic of China gained the membership in the United Nations in October 25, 1971. Previously, its seat was occupied by the Taiwanese delegates of Republic of China. Since 1980 the PRC has participated in the UNCITRAL mission and became a member of this body in 1983. From the very beginning China involved itself into the preparation of Vienna Convention on Contracts for the International Sale of Goods. The PRC delegation, led by Mr. Li Chih-min attended the 1980 Diplomatic Conference in Vienna. The participation of China in this conference was quite particular, because so far there was no PRC's domestic legislation in codified form on the subject of contract law or civil law in general. The Reforms and Opening-up process just started in 1978 and till 1980 no major civil legislative acts were prepared.

Chinese delegation was an active participant in the drafting process⁷². Head of the delegation, Mr. Li Chih-min expressed the Chinese concern of this Convention in following words:

Convention would be of great importance in the gradual removal and final elimination of the barriers to international trade, especially as the affected the developing countries, the elimination of certain inequitable and unjust situations in international trade and its promotion on the basis of equality and mutual benefit⁷³.

As for the breach of contract and damages, during the drafting and formation process there were no questions or proposals raised by the Chinese delegation⁷⁴.

72 F. Yang, The application of the CISG in the current PRC Law and CIETAC Arbitration practice, *Nordic Journal of Commercial Law*, vol. 2 (2006), p.6.

73 *Legislative History 1980 Vienna Diplomatic Conference*:
<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting5.html>

74 The articles that raised concerns of the PRC delegation include Draft Article 5 [became CISG Article 6], Draft Article 6, 7 [became CISG Article 7, 8], Draft Article 8 [became CISG Article 9], Draft Article 3 [became CISG Article 3], Draft Article 17 [became CISG Article 19], Draft Article 23 [became CISG Article 25], Draft Article 34 [became CISG Article 36], Draft Article 36 [became CISG Article 38], Draft Article 42 [became CISG Article 46], Draft Article 37 [became CISG Article 39], Draft Article 61 [became CISG Article 65], Draft Article 69 and interest [became CISG Article 84, 78], Draft Article 75 [became CISG Article 86], Draft Article 62(1) [became CISG Article 71(1)], Draft Article 63(2) [became CISG Article 72(2)]; Article C *bis* [not adopted], Article (X) [became CISG article 96], Article E [became CISG article 100 and Articles 39 and 40 [became CISG article 41, CISG article 42 and CISG article 43], Article 80 [became CISG article 68].

China signed the CISG on September 30, 1981 and ratified it together with US and Italy on 11 December 1986⁷⁵. The CISG entered into effective on 1 January 1988. The ratification of the CISG expressed the government's attitude toward it: „it attained beneficial experiences from different countries but not necessarily tainted by one or two countries' super-will”⁷⁶. Before the ratification a intensive research on the CISG was carried on in China. Some officials in the Ministry of Foreign Trade and Economic Cooperation (“MOFTEC”) - *Zhongguo Renmin Gongheguo Shangwubu* appointed to do research on whether China should ratify the CISG published their own books explaining the CISG, from which the Yuqing Zhang book⁷⁷ is considered one of the best and it serves as a basic handbook for Chinese law practitioners.

The experience gained during the process of drafting the CISG was used during the legislative works on Chinese domestic civil law. Not only some legal institutions were regulated in similar way, but also general principles of the CISG were implemented into Chinese civil law. It is said that the law of the PRC now 'shares the core spirit embodied in the [CISG]’⁷⁸.

Certain rules from the CISG were already applied to the FECL, e.g. measures to specify damages (Art. 61(1)(b), (2), Arts. 74, 77 of CISG, Arts.18-19, 22 FECL) and the application of international customs (Art. 9 CISG, Art. 5 FECL). Crucial differences between the two acts still existed: the FECL relied on the so-called 'subjects with foreign elements' while the CISG relies on 'places of business'. Moreover, the FECL denied the validity of oral contracts and contracts by conduct⁷⁹. It may be also worth noticing, that the FECL had some impact on the UNIDROIT Principles⁸⁰.

The coverage of the Chinese Contract Law is much larger than the CISG, but the common provisions are generally similar. The drafters decided to harmonize the CCL with

F. Yang, *op. cit.*

75 Y. Zhang, *Harmonization of contract law and its impacts on China's contract law*, Modern Law for Global Commerce: Congress to celebrate the fortieth annual session of UNCITRAL (2007), p. 2.

76 D. Ding, *op. cit.*, p. 36.

77 Y. Zhang, *The Uniform Law on International Sales of Goods—Explanations on the CISG*, Beijing: China Foreign Economic Relations and Trade Press (1998).

78 H. Danhan, *The UNIDROIT Principles and Their Influence in the Modernisation of Contract Law in the People's Republic of China*, *Uniform Law Review* (2003), p. 107.

79 D. Ding, *op. cit.*, p. 30.

80 B. Fuchs, *Lex mercatoria w międzynarodowym obrocie handlowym* (2000) [Lex mercatoria in international trade], p.68

the CISG for several reasons, from which one of the most important is decreasing transaction costs of cross border transactions, which would be significantly greater if Chinese domestic legal system was very different from the international uniform instruments⁸¹. Also the understanding of the CISG in China would be better, since Chinese judiciary will be able to draw, in essence, on the same principles⁸². On the other hand, understanding of the CISG will be helpful for a business person in understanding fundamentals of the Chinese Contract Law⁸³. So the disputes arising between Chinese parties and the western counterparts may be similar to those arising between Turkish seller and Swiss buyer, since Turkey has generally the same civil code as Switzerland.

The CCL and the CISG have a lot of common principles including: principles of autonomy (art. 2, 3, 4 and 12 CCL); binding character of contract (art. 8 CCL), good faith (art. 5 CCL), formation of contract: offer and acceptance (art. 9, 10, 11 CCL), authority of agents (art. 396, 400, 402, 414 CCL). Since the precise comparison of these two acts is outside the scope of this work the analysis in following chapters will focus on the comparison of breach of contract and damages. In the chapters 5 of this work a comparison between concepts of breach of contract (strict liability under the CISG, and probably a fault principle under the CCL) and the system of damages would be presented.

To sum up, it is now 'almost compulsory'⁸⁴ to base any revision of domestic code on a comparative study, which normally includes international conventions and soft law. China is a great example of 'transplantation' (Alan Watson term⁸⁵) of the CISG into domestic law and its contribute significantly to international harmonization of laws. The CISG influence dates back to the drafting process of the FECL in 1985. Due to political and economic system constrains of that time many of the CISG provisions were not introduced into the FECL.

Nevertheless, China recognized the importance of international trade and participated

81 B. Zeller, *The significance of the CISG for the harmonization and transplantation of international commercial law*, (2002), p. 11.

82 *Ibidem*, p. 13.

83 *Ibidem*, p. 13.

84 B. Zeller, *CISG and the Unification of International Trade Law*, (2007), p. 81.

85 A. Watson, *Legal Transplants: An Approach to Comparative Law* (1993), p. 117.

The author, however, do not fully agree with Watson's theory of legal transplants. Firstly, Watson underestimates the importance of law culture, which may be a serious obstacle for transplantation or make the transplanted law change. Secondly, the issue of origin of certain law, a place from which it was transplanted is not as significant as the way in which the transplanted law really function. Therefore, not the historical approach of origin of law, but pragmatist approach of the way it is applied should be emphasized.

actively in the drafting process of the CISG and when it turned into capitalism, the new code - CCL was adopted. It was obviously inspired by the CISG in far more significant extent.

3.2. Reservations and general application of CISG in China

The People's Republic of China has made two reservations to the CISG. Short analysis of them would be important for the further inquiry in application of CISG in China.

The Article 95 Reservation⁸⁶ states that: "The People's Republic of China does not consider itself to be bound by subparagraph (b) of paragraph 1 of article 1 . . . "⁸⁷.

Upon this reservation if a seller in the PRC sells goods to a buyer in a non-Contracting State, then CISG will not apply, even if the relevant rules of private international law lead to the application of the PRC law. The reasons for making this reservation on conclusion of the CISG was: immature economic background, early stage of Reform and Opening-up, lack of domestic legislation⁸⁸. It is stated that this reservation should be withdrawn, because great changes occurred in China during past 20 years, the legal system is far more developed and the international trade is well received⁸⁹.

Upon the article 96 Reservation „The People's Republic of China does not consider itself bound by [...] article 11 as well as the provision of the Convention relating to the content of article 11.”⁹⁰ As an effect of this reservation, art. 11 CISG, which establish freedom of form do not apply to Chin and therefore the matter of form of contract would be regulated by the conflict of provisions and relevant governing law would indicate whether there are any restrictions to the form of contract.

The Chinese law previously demanded the writing form for contracts:

art. 3 ECL 1981:

Economic contract, except when payment is made immediately, shall be in writing, document, telegram or telex on

⁸⁶ Introduced by Czechoslovak representative in the 11th plenary meeting of the 1980 Vienna Diplomatic Conference

F. Yang, *op. cit.*, p. 7.

⁸⁷ <http://www.cisg.law.pace.edu/cisg/countries/cntries-China.html>

⁸⁸ F. Yang, *op. cit.*, p. 7.

⁸⁹ Y. Xiao, W. Long, *Selected Topics on the Application of the CISG in China*, p. 102-103.

⁹⁰ <http://www.cisg.law.pace.edu/cisg/countries/cntries-China.html>

alteration of the contract by mutual agreement between parties form part of the contract⁹¹

art. 7 FECL 1985:

A contract shall be formed as soon as the parties to it have reached a written agreement on the terms and have signed the contract (...)⁹²

Nevertheless, the aforementioned acts are not in force since 1999, when the CCL was adopted. Contrary to the previous legal acts the CCL generally do not restrict contract form:

art. 10 CCL 1999:

a contract may be made in a writing, in an oral conversation, as well as in any other form.

A contract shall be in writing if a relevant law or administrative regulation so requires. A contract shall be in writing if the parties have so agreed.⁹³

The analysis of the CISG, Chinese reservations to it and the CCL leads to the conclusion that the freedom of form principle do not apply to contracts concluded under the CISG, but on the other hand apply to those concluded under the CCL, if relevant domestic law do not restrict it. Some scholars suggest that, since in China a written form is no longer obligatory, art. 96 reservation is not longer valid⁹⁴. This interpretation rather goes too far, because reservations could be withdrawn by „formal notification in writing addressed to the depositary” (art. 97(4) CISG).

The art. 96 reservation was made to protect Chinese parties from the more experienced western businessmen who could use law loopholes for their own benefits. Moreover, by the time of enacting the CISG there was a strict control over business in China. The softer regulations were introduced not before 1999. Since the legal environment had changed and China gained experience in international trade it should be suggested to withdraw art. 96 reservation. The reservation is not only inconsistent with the informality principle of the CCL⁹⁵, moreover the written form of contracts is foreign to Chinese

91 F. Yang, *op.cit.*, p. 13.

92 *Ibidem*, p. 13.

93 Official PRC translation: <http://www.chinalaw.gov.cn>

94 F. Yang, *op. cit.*, p. 15.

95 S. Presilla, *The influence impact of the CISG in the PRC Legal System*, Rome 2009;

tradition, which preferred oral contracts⁹⁶.

As for the general application of CISG it should be noted that at present neither Chinese constitution, nor the basic law contain any provisions on the legal status of international treaties and their hierarchy in the domestic legal system. Therefore, international treaties do not automatically become a part of national law and consequently do not automatically have domestic legal effect⁹⁷.

China is now part of over 300 multilateral treaties and over 70 domestic laws with provisions touching upon treaty obligations. These provisions generally state that when there is a difference between Chinese domestic law and international treaty provision the treaty prevails, but it is not a general rule⁹⁸. In practice there are three forms to implement treaty obligation: execution by administrative measures, transformation of treaty obligations and direct application⁹⁹.

The application of the CISG is regulated by rules on civil law international treaties in the PRC General Principles of Civil Law, art. 142:

The application of law in civil relations with foreigners shall be determined by the provisions in this chapter.

If any international treaty concluded or acceded to by the People's Republic of China contains provisions differing from those in the civil laws of the People's Republic of China, the provisions of the international treaty shall apply, unless the provisions are ones on which the People's Republic of China has announced reservations. International practice may be applied to matters for which neither the law of the People's Republic of China nor any international treaty concluded or acceded to by the People's Republic of China has any provisions¹⁰⁰.

In the light of this article it is clear that the CISG is superior to the PRC domestic legislation and it should be applied directly¹⁰¹. The CISG generally do not apply in Hong Kong, Macao and Taiwan, but this issue is still controversial¹⁰². However, if parties from Hong Kong or PRC reached consensus that the CISG is the applicable law, it applies, e.g. Copper cable

<http://www.abogaciaglobal.com/articles/The%20influence%20impact%20of%20the%20CISG%20in%20the%20PRC%20Legal%20System.html>

96 F. Yang, *op. cit.*, p. 13.

97 H. Xue, Q. Jin, International Treaties in the Chinese Domestic Legal System, *Chinese Journal of International Law* vol.8 no. 2 (2009), p. 300.

98 *Ibidem*, p. 303.

99 *Ibidem*, p. 305.

100 Official PRC translation: <http://www.chinalaw.gov.cn>

101 H. Xue, Q. Jin, *op. cit.*, p. 310.

102 L. Wei, The Interpretation of the CISG in China, in: André Janssen / Olaf Meyer eds., *CISG Methodology*, Sellier European Law Publishers (2009), p. 346.

case¹⁰³, Rebar coil case¹⁰⁴. The controversy arises, because after transferring the sovereignty of those former colonies to China in 1997 (Hong Kong) and 1999 (Macao), the system “one country, two systems” was introduced. It was an idea proposed by Deng Xiaoping, according to which those territories could have their own constitution, legal, economic and political system, even enjoying certain rights in foreign affairs. The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China was enacted in 1990 (entered into force in 1997) and the Basic Law of the Macau Special Administrative Region of the People's Republic of China, which is effective since 1999. Because of the partly independence on legal, economic and political grounds Hong Kong and Macao are treated for purposes of the CISG as separate countries. The case of Taiwan is quite different, because it has not joined “one country, two systems” (*yiguo liangzhi*) scheme and try to maintain its independence. Nevertheless, those territories are not recognized by UN as Member States and are not parties to CISG.

103 China 15.05.1995 CIETAC Arbitration proceeding (Copper cable case):

<http://cisgw3.law.pace.edu/cases/950515c1.html>

104 China 20.11.1997 CIETAC Arbitration proceeding (Rebar coil case):

<http://cisgw3.law.pace.edu/cases/971120c1.html>

4. The CISG and the CCL: law of damages

4.1. General remarks on the law of damages

Damages for breach under the CISG could be defined as a monetary compensation for the loss suffered by the injured party (74 CISG, see also: 7.4.2. UPICC, 9:502 PECL). As in common law they are generally seen as a monetary damages¹⁰⁵. English version of the CISG is (unlike, for example, German one¹⁰⁶) clear in this matter: „damages...consist of a sum equal to the loss...” (art. 74 CISG). Damages are applicable to any case where other remedies are not suitable or adequate.

The main purpose of damages is to compensate the loss. Moreover, remedies and damages in particular are said to serve also the goal of keeping peace through the prevention of private wars¹⁰⁷ and to having a deterrent effects¹⁰⁸. They are vital for the effective operation of contract law and without them international trade would be substantially undermined.

For the damage claim to be effective three prerequisites should be fulfilled:

- 1) one party has committed a breach of contract;
- 2) the other party suffered loss, recognized by the instruments as recoverable;
- 3) the loss has occurred as a consequence of the breach.

The right to claim damages does not depend on fault (so-called no-fault rule¹⁰⁹) as it is in some domestic systems, where it depends on actual (subjective) fault or on negligence (objective)¹¹⁰. On the contrary, the UPICC establish a distinction, based on French law, between a duty 'to achieve a specific result' (art. 5.1.4(1) UPICC) and a duty 'to exert best efforts' (*obligation de moyen*) (art. 5.1.4(2) UPICC). The Chinese Contract Law generally

105 P. Schlechtrim, P. Butler, *op. cit.*, p. 199.

106 Als Schadenersatz für die durch eine Partei begangene Vertragsverletzung ist der der anderen Partei infolge der Vertragsverletzung entstandene Verlust, einschließlich des entgangenen Gewinns, zu ersetzen. Dieser Schadenersatz darf jedoch den Verlust nicht übersteigen, den die vertragsbrüchige Partei bei Vertragsabschluß als mögliche Folge der Vertragsverletzung vorausgesehen hat oder unter Berücksichtigung der Umstände, die sie kannte oder kennen mußte, hätte voraussehen müssen.

107 D. Saidov, *The law of damages in the international sales of goods: the CISG and other international instruments*, (2008), p. 17.

108 *Ibidem*, p. 19.

109 I. Schwenzer, Ch. Fountoulakis, *op. cit.*, p. 517.

110 D. Saidov, *op. cit.*, p. 21-22.

emphasizes the fault rule¹¹¹.

The general principle ruling the law of damages of the CISG is the principle of full compensation, which has its roots in Roman Law¹¹². The compensation therefore should include both loss suffered and gains prevented. The principle of full compensation is widely recognized (art. 74 CISG, art. 7.4.2 UPICC, 9:502 PECL) and it „is so well settled that it can be said it has become a general rule of private international law”¹¹³. As it was mentioned before, under the ECL, which is not in force since 1999, the punitive function of damages was emphasized. It also provided mandatory provisions on damages, which left a little freedom to the parties. Moreover, before 1999 after compensation for a breach of contract party still could require to continue performance¹¹⁴. In this matter the ECL was strictly in line with planned economy policy. The FECL and the GPCL did not reflected planned economy in such matter. The CCL also gives more freedom to parties as for claiming damages, allowing both compensatory and liquidated damages¹¹⁵. It also emphasizes the compensatory function of damages not the punitive one as the ECL, but nevertheless in certain extent allow the punitive damages.

Regarding China, the damages are so far most frequently sought remedies under the CISG¹¹⁶ (the other remedies that party may claim are: continued performance, remedial measures (*bujiu cuoshi*) including repair, exchange, redo, return and reduction of payment)¹¹⁷. The damages awarded by Chinese courts include, for example, arbitration expenditures¹¹⁸, storage fees¹¹⁹, freight¹²⁰, loading and unloading fees¹²¹, fees for issuing a

111 This topic would be elaborated in Chapter 5.2.

112 D. Saidov, *op. cit.*, p. 25.

113 Prof. J.Y. Gotanda after: D. Saidov, *op. cit.*, p. 40.

114 J. Chen, *op. cit.*, p. 457.

115 J. Chen, *op. cit.*, p. 458.

116 Y. Xiao, W. Long, Selected Topics on the Application of the CISG in China, *Pace International Law Review* (2008), p. 93.

117 P. B. Potter, *op. cit.*, p. 49.

118 China 18 March 2005 Beijing High People's Court, <http://cisgw3.law.pace.edu/cases/050318c1.html>

119 China 10 May 1996 CIETAC, <http://cisgw3.law.pace.edu/cases/960510c1.html>

120 China 6 March 1997 CIETAC, <http://cisgw3.law.pace.edu/cases/970306c1.html>

121 China 16 August 1996 CIETAC Arbitration proceeding, <http://cisgw3.law.pace.edu/cases/960816c1.html>

letter of credit¹²², inspection fees¹²³, import fees¹²⁴, fees for cleaning containers¹²⁵, and insurance fees¹²⁶.

As it has been mentioned before the CISG rely on the distinction of 'loss suffered' (*damnum emergens*) and 'loss of profit' (*lucrum cessans*). There are several reasons for this distinction. Firstly, there are instances where gains prevented could not be claimed, for example, art. 44 CISG states that, if a buyer has a reasonable excuse for his failure to give the required notice, the loss of profit may not be claimed. Secondly, *lucrum cessans* is not recognized by all domestic legal system. For example, it is not provided in civil regulations of Jordan and United Arab Emirates¹²⁷.

The CISG clearly mentions loss profits as the part of damages claimable to avoid misunderstanding in this matter. However, claiming loss of profit is not specifically recognized in the Chinese Contract Law. Since the CCL shares with the CISG the general principle of full compensation lost profits may be included into term 'equal to the loss'. Still, scholars argue whether lost profits are or should be part of the Chinese law remedial scheme and how they should be calculated¹²⁸. This may be the main reason of lack of consistent judiciary decisions regarding loss of profit, which will be shown in further case analysis. In the various decisions under the CISG made by Chinese arbitration courts the loss of profit was defined as: difference between the contract price and the actual production costs of the goods or a gross profit from which such normal costs as customs duties and value added taxes were deducted¹²⁹. Moreover, the compensation is to be made also for any foreseeable

122 China 31 December 1997 CIETAC Arbitration proceeding (Lindane case),
<http://cisgw3.law.pace.edu/cases/971231c1.html>

123 China 7 July 1997 CIETAC Arbitration proceeding (Isobutanol case),
<http://cisgw3.law.pace.edu/cases/970707c1.html>

124 China 7 January 2000 CIETAC Arbitration proceeding (Cysteine case),
<http://cisgw3.law.pace.edu/cases/000107c1.html>

125 China 10 September 2004 High People's Court [Appellate Court] of Shandong Province,
<http://cisgw3.law.pace.edu/cases/040910c1.html>

126 China 1997 Shanghai High People's Court (Akefamu v. Sinochem Hainan),
<http://cisgw3.law.pace.edu/cases/970000c1.html>

127 Secretariat Commentary, Guide to CISG Article 74, <http://cisgw3.law.pace.edu/cisg/text/secomm/secomm-74.html>

128 S. Singh, B. Zeller, CIETAC's calculation on lost profits under article 74 of the CISG, *Loyola University of Chicago International Law Review*, vol. 4, issue 2, (2007), p.212.

129 China 30 January 1996 CIETAC Arbitration proceeding (Compound fertilizer case)
<http://cisgw3.law.pace.edu/cases/960130c1.html>

China 17 October 1996 CIETAC Arbitration proceeding (Tinplate case)
<http://cisgw3.law.pace.edu/cases/961017c1.html>

China 10 July 1997 CIETAC Arbitration proceeding (Carbomide case)
<http://cisgw3.law.pace.edu/cases/970710c1.html>

gains that would have been achieved after the judgment date¹³⁰. It is unclear how Chinese courts deal with this matter, when they recognize case under the CCL not the CISG, because the verdicts published often lack reasoning and argumentation. Nevertheless, the loss of profit in the light of full compensation principle is recognized under the CCL, however its nature is unclear.

Apart for aforementioned compensatory damages, that serve the purpose of placing the aggravated party in the same position as it would be if the contract had been performed as agreed upon by the parties, the CCL provides also three other kinds of damages: liquidated damages (*weiyuejin*), punitive damages (*cheng fa xing sun hai pei chang*), earnest money (*dingjin*). Those kinds of damages are not recoverable under the CISG, which provides only compensatory damages.

The liquidated damages, called also stipulated damages, are a certain amount of damages agreed upon by the parties in the contract, that a party in breach is supposed to pay as the compensation to the aggrieved party. The extent of those damages does not depend on actual loss, but solely on the agreement of the parties. The parties may agree on certain amount of damages or on a particular formula by which they will be calculated.

Generally, the liquidated damages serve a compensatory function, but they also may constitute a penalty against the party in breach¹³¹. An important function of damages is to deter the breach and whoever fails to perform contract has to face economic punishment. Moreover, the court or arbitrary body may not aside the liquidated damages without request of the interested party and even if there is such a request court may still prescribe the damages as agreed in contract. This rule is provided by art. 114 CCL which states that when the amount of liquidated damages is below the loss resulting from the breach, a party may petition the People's Court or an arbitration institution to increase the amount; where the amount of liquidated damages prescribed exceeds the loss resulting from the breach, a party may petition the People's Court or an arbitration institution to decrease the amount as appropriate. Furthermore, under the same article, if the liquidated damages are agreed in respect to the delay in performance, the party in breach is still obligated to continue performing its obligation after the liquidated damages are paid.

130 S. Singh, B. Zeller, *op. cit.*, p.216.

131 M. Zhang, *op. cit.* p. 309.

The punitive damages played an important role under the ECL. In the CCL they are strictly limited as applied in contracts, but nevertheless not eliminated. Their main purpose is to punish the party in breach, so the amount of damages is normally much higher than the actual loss. Art. 113 CCL requires a cross reference to other law and indicates that the punitive damages deal primarily with fraudulent activities. The cross reference provisions indicated in art. 113 is the Law of Protection of Consumers' Rights and Interests, promulgated on October 31, 1993, which in art. 49 stipulates that if the business operators are found to have committed fraudulent conduct in providing goods or services, the damages for loss caused to consumers shall be multiplied on the demand of the consumers. The amount of increased compensation to the losses suffered by the consumer is one times of the commodity price or service charges that the consumer has paid for the commodity purchased or for the service accepted.

The last type of damages provided by the CCL is the earnest money. The parties may agree to provide a certain amount of money, usually a certain percentage of the contract price¹³², as security to guarantee the performance of the contract. Prior to adoption of the CCL, earnest money was provided both by the GPCL and the 1995 Guaranty Law of China as a type of the security to guarantee the creditor's rights. The Contract Law makes the earnest money a kind of remedy of breach of contract¹³³. The art. 115 CCL stipulates that:

The parties may prescribe that a party will give a deposit to the other party as assurance for the obligee's right to performance in accordance with the Security Law of the People's Republic of China. Upon performance by the obligor, the deposit shall be set off against the price or refunded to the obligor. If the party giving the deposit failed to perform its obligations under the contract, it is not entitled to claim refund of the deposit; where the party receiving the deposit failed to perform its obligations under the contract, it shall return to the other party twice the amount of the deposit.

One of the most important features of earnest money is that they may not be employed to replace damages. If the breach occurs, the aggrieved party may not only keep the earnest money, but also demand the party in breach to continue performing the contract or seek damages¹³⁴. Nevertheless under art. 116 CCL the earnest money could not be claimed

132 *Ibidem*, p. 310.

133 *Ibidem*, p. 311.

134 *Ibidem*, p. 311.

simultaneously with the liquidated damages. The aggrieved party in case of breach have to choose between one of those damages.

There is also, according to art. 90 of Guarantee Law of the PRC, a writing requirement for an agreement providing the earnest money. Moreover, the art. 91 of Guarantee Law provides that the earnest money may not exceed 20 percent of the contract price. If it does so, the amount will be reduced to the 20 percent.

Damages provided both by the CISG and the CCL serve mainly the compensation function and tend to recover both the loss suffered and the loss of profit. The CCL however retains some punitive functions of damages. The law of damages provided by the CCL is far more extensive and it also establishes liquidated damages, punitive damages and the earnest money. The main difference between the CISG and the CCL is that the latter is generally based on the fault principle, not the strict-liability as the CISG.

4.2. Breach of contract

The CISG is based on the concept of unitary breach of contract, which could be defined as failing to perform any of obligations arising under the contract or under the CISG¹³⁵. This concept, which has its origins in common law systems, is contrary to arising from Roman Law system of various forms of violations of contract causing different kinds of liability. The breach of contract under the CISG is not dependent on fault or negligence of the party. The fact of a breach is all that matter.

The CISG introduce also the concept of fundamental breach of contract. If it occurs the contract may be terminated. Fundamental breach could be committed by either the seller, which is more common, or by the buyer. The main features of this kind of breach are “substantial deprivation” and “foreseeability”.

According to art. 25 CISG a breach is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result. To put it simply, breach is

135 P. Huber, A. Mullis, *op. cit.*, p. 257.

significant, if the creditor does not get substantially what he or she could have expected under the provisions of contract. So, it is the significance for the creditor, not extent of damages what makes the breach fundamental¹³⁶. Normally, a fundamental breach would occur, when the performance would be made impossible by objective or subjective circumstances. If it is still possible, then the importance of agreed date would determine whether the breach is fundamental or not, e.g. the delay of delivery of seasonal goods or a wedding dress would be a fundamental breach, and therefore contract could be avoided without additional time for delivery. Moreover, whether the duties were the main obligations laid by the contract or were only ancillary duties do not matter. Like in previous example, the significance that a party attach to certain obligation matters¹³⁷. Fundamental breach rarely occurs in cases of defective performance. If the defect could be rectified in reasonable time a party could not claim it to be a fundamental breach. Nevertheless, if the defect is so severe that it cannot be rectified in reasonable time nor are the goods useable or sellable even at a loss, then party may avoid contract¹³⁸.

The buyer may also commit a fundamental breach of contract. He has generally two obligations: to pay the price and accept delivery. In regard to the payment of the purchase price case law suggest that a delay in payment rather would not be considered a fundamental breach¹³⁹. Nevertheless, the buyer's insolvency might be such an exceptional circumstance that would give seller right to avoid the contract as in the *Roder Zelt-und Hallen Konstruktionen GmbH v. Rosedown Park Pty Ltd*¹⁴⁰. If buyer definitely refuse to accept deliver he commits a fundamental breach, because seller must be able to free himself from the contract. This test is rather objective than subjective. It does not matter what the promisee actually expected, but what he was entitled to expect¹⁴¹.

Even when the party was substantial deprived of what he or she had expected the avoidance of contract under art. 25 will not be possible, if the result of breach was not foreseeable. The foreseeability test is described broadly in chapter 5.3.2 of this work. In this

136 *Ibidem*, p. 214.

137 P. Schlechtriem, P. Butler, *op. cit.*, p. 99.

138 *Ibidem*, p. 100.

139 *Ibidem*, p. 101.

140 <http://www.cisg.law.pace.edu/cases/950428a2.html>

141 P. Huber, A. Mullis, *op. cit.*, p. 215.

place it should be noted that there is a difference between art. 25 and art. 74 CISG. The first of them do not prescribe the time when the result of breach should be foresaw. This issue was deliberately left open by the Diplomatic Conference. The predominant view is that it will depend on the predictions on the time of the conclusion of contract¹⁴². This view is in line with the features of general rule of foreseeability.

Another important provisions regarding breach are art. 71, 72 CISG, which deal with the anticipatory breach. If it becomes apparent that one party will commit a breach of contract, another party may suspend its performance or even stop the goods that already had been dispatched, although the date of performance has not yet arrived. The CISG provide comprehensive regulation of such cases which should exclude any national regulation, if the CISG is the governing law of contract¹⁴³.

The prerequisite for suspending the performance is apparent future non-performance of a substantial part of contract resulting from:

- a) a serious deficiency in his ability of perform or in his creditworthiness; or
- b) his conduct in preparing to perform or in performing the contract.

The term “substantial” does not mean “fundamental” in the sense of art. 25 CISG¹⁴⁴. As in the general breach of contract concept, there is no fault requirement. The circumstances described in point (a) and (b) might refer to: strikes, wars, natural disasters, embargos, individual impediments, insolvency or sellers performance, e.g. using improper materials¹⁴⁵.

If those circumstances occur, another party may suspend its performance or even preparations for it. Nevertheless, art. 71 CISG does not give right to avoid contract, before the due date of performance. The right to suspend ends if the other party provides adequate assurance of performance (art. 73(3) CISG) or a threat of breach disappears.

The Chinese Contract Law generally introduced regulation of breach of contract (*weiyue*) as it is described in the CISG. Unitary concept of breach of contract is not a new idea in the Chinese law. It existed previously under the provisions of the FECL.

142 *Ibidem*, p. 216.

143 *Ibidem*, p. 339.

144 *Ibidem*, p. 340.

145 *Ibidem*, p. 341.

In the CCL it has two forms: actual breach and anticipated breach¹⁴⁶. There is no concept of fundamental breach in Chinese law¹⁴⁷.

The actual breach is a failure to perform the contract in due time. Article 107 CCL divide actual breach into two types:

- a) non-performance of contract obligation (*bu lüxing hetong yiwu*);
- b) non-conforming performance (*lüxing hetong yiwu bu fuhe yueding de*).

The non-performance occurs when a party completely fails to perform its obligation. This term is sometimes used interchangeably with breach of contract. That is a mistake, because breach of contract could have various forms, not only non-performance. Non-performance may include impossibility to perform or refusal to perform. The classic Roman law maxim “*impossibilium nulla obligatio est*” is embodied within the Chinese Contract Law¹⁴⁸. No liability would be laid on a party who could not perform obligations that are objectively impossible to perform.

The non-conforming performance means that obligor had carried on his duty, but in improper or incomplete way. The performance would be deemed as incomplete if not the whole obligation would be fulfilled. The properness requires obligor to perform the contract in the way that the quality, quantity, time, location as well as manner of the performance match the conditions agreed in the contract.

The CCL also regulates in art. 94 (II) the anticipatory breach (*yuqi weiyue zhidu*). The circumstances to which anticipatory breach applies are similar to those described in the CISG: party expressly stated or indicated by its conduct that it will not perform its main obligations. Nevertheless, there is a significant difference between the CISG and the CCL – if the aforementioned prerequisites occur, a party may terminate the contract, not suspend performance as in the CISG. The suspension of performance is regulated in art. 68 CCL under which the party required to perform first may suspend its performance if it has conclusive evidence establishing that the other party is in any of the following circumstances:

- (a) Its business has seriously deteriorated;

146 M. Zhang, *Chinese Contract Law: Theory and Practice*, Leiden 2006, p. 294.

147 *Ibidem*, p. 295.

148 *Ibidem*, p. 294.

- (b) It has engaged in transfer of assets or withdrawal of funds for the purpose of evading debts;
- (c) It has lost its business creditworthiness;
- (d) It is in any other circumstance which will or may cause it to lose its ability to perform.

Nevertheless, if a party suspends performance without conclusive evidence, it shall be liable for breach of contract.

“Liability for breach” (*weiyue zeren*) is a heavily discussed term in Chinese legal doctrine which is also claimed to be a “product of China”¹⁴⁹. This concept was recognized as early as under 1981 ECL. Liability for breach is defined as “the civil liability that arises from the conduct of violation of a contract”¹⁵⁰. It may sound quite simple, but there are nevertheless four major views presented by scholars on this topic. One view is that this liability is the legal consequence which a party must face if it fails to perform its obligations under the provisions of contract. The second view states that it is a responsibility of the party in breach to compensate the damages suffered by the aggravated party. The next view emphasizes punishment by defining liability for breach as a legal sanction. The fourth view states that it is the legal assurance for the contract performance, and in case a party defaults in performance, the other party may ask the court to enforce the right against the party in default. These four views are not contradictory, but rather each of them emphasizes different side of liability for breach.

There are two main principles governing liability for breach in Chinese law:

- a) Principle of liability;
- b) Doctrine of liability imputation.

Under the first, a person will be legally liable for failure to fulfill his or her obligation required by law. This principle is stated in art. 106 GPCL:

Citizens and legal persons who breach a contract or fail to fulfill other obligations shall bear civil liability.

Citizens and legal persons who through their fault encroach upon state or collective property or the property or person of other people shall bear civil liability. Civil liability shall still be borne even in the absence of fault, if the law so stipulates.

149 *Ibidem*, p. 291.

150 *Ibidem*, p. 291.

In the light of this article liability is a legal consequence that the obligor faces in case he or she defaults. It should be highlighted that reference to “state or collective property”, which was introduced under different politico-economic circumstances, still remains in the GPCL.

The second principle is the doctrine of liability imputation, a process of determining whether the party in breach shall be responsible for the breach of contract. More attention should be laid on this principle, because in some aspects it differs from the CISG regulation. Shortly speaking, it requires that the civil liability be imposed for what should be legally blamed¹⁵¹.

In civil law theory two basic approaches are taken to impute civil liability: the fault approach and no-fault approach (strict liability). As it has been mentioned before, the CISG embodied the no-fault approach – a party may claim damages if the other party breaches the contract regardless of the fault of the failing party. In the case of the Chinese Contract Law the matter is far more complicated. The law itself seems to be vague as to what standard of liability is being applied.

Before the CCL was adopted Chinese law tended to employ solely the fault-based approach (*guocuo*). Art. 29 of the ECL provided that if due to the fault of one party, an economic contract cannot be performed or cannot be fully performed, the party at fault shall be liable for breach of the contract. As for the GPCL, when its draft was submitted to the National People's Congress for vote, the Standing Committee of the NPC indicated that the primary standard in determination of civil liability was the principle of fault¹⁵².

The controversy arose when the CCL was adopted. Art. 107 CCL does not mention fault as an element of liability for breach of contract. Does it mean that the fault principle was abandoned and strict-liability introduced?

One view is that art. 107 CCL, which is based on the CISG, employs the CISG's strict-liability principle. Another argument for this view is that even *force majeure* (*bu ke kang li*), defined as “objective circumstances that cannot be foreseen, avoided or overcome”, do not necessarily exempt party fully from contractual obligation, if circumstances or other legal provisions indicate so (art. 117 CCL). If *force majeure* do not always exempt party from liability why should the fault do so?

151 *Ibidem*, p. 290.

152 *Ibidem*, p. 292.

The second view emphasized the principle of fault. The CCL is still within the system created by the GPCL and do not expressly introduce the strict-liability. Therefore, the previous principles of the GPCL should remain. Moreover, the CCL employs fault-based liability in many other areas such as pre-contractual liability, reasonably foreseeable loss or risk, mitigation rule, burden of risk¹⁵³.

The third view presents *aurea mediocritas*, claiming that the CCL contains both fault and strict-liability principles with emphasis on the latter. This view nevertheless seems impractical and do not provide a clear border between those two standards.

The majority view is that the fault principles embodied in the GPCL has not been so far abandoned. It could suggested *de lege ferenda* that in the new Civil Code, which would cover both the GPCL and the CCL, the strict-liability principles should be introduced, so the Chinese Law would be in line with modern trends of international trade law.

4.3. Methods of limiting damages:

The CISG provides several methods to limit the damages so the full compensation principle would not be exceeded. The following chapter will provide inquiry about three basic methods of limiting damages: causation, foreseeability and mitigation.

4.3.1. Causation

The one of the most important methods of limiting damages is the principle of causation. The only loss recoverable under the CISG is the loss, which occurred „as a consequence of the breach¹⁵⁴. The party is not liable for the loss which is not caused by its breach. The connection between breach and loss is said to be a 'necessity of human thought'¹⁵⁵, and is recognized by many domestic legal systems. The main problem concerning causation is how this connection should be assessed.

Firstly, there should be noted that there is a main difference between legal causation

153 *Ibidem*, p. 293.

154 Art. 74 CISG (compare: UPICC 7.4.2(1) and 9:501(1) PECL)

155 D. Saidov, *op. cit.*, p. 79.

and the factual causation. The first inquiry what are the legal consequences attached to the breach and other events in the chain of events. The second only regard the history of events leading to the loss. It is important to have in mind this distinction, because the legal causation inquiry can only be made after the facts are established¹⁵⁶. There are several theories concerning the relation between the event in the chain leading to the loss and the loss itself.

Equivalence theory states that every condition in the absence of which the harm would not have occurred in the way in which it did occur is a cause of the harm. It is a simple test based on the 'but for rule' called also '*sine qua non rule*'¹⁵⁷. The court inquiry whether there was any other cause or the loss would occur 'but for' the defendant's actions. This theory however may lead to excessive liability and other factors and limitations should be regarded.

Under the so called NESS test (Necessary Element of a Sufficient Set) introduced by prof. Richard Wright in 1985, something is a cause if and only if it is a 'necessary element of a set of antecedent actual conditions that was sufficient for the occurrence of the consequence'¹⁵⁸. The NESS test checks not the sufficiency of a factor, but the necessity. In the aforementioned multiple sufficient causation the damages claim would serve against the party, which actions had the predominating influence on the harm.

The aforementioned 'but for' test has drawbacks especially in a multiple sufficient causation cases, which occur, if two or more events independently result in the consequence and each of them is sufficient in itself to bring about this consequence. In such case, if one of these events would not occur, the same consequence would happen anyway¹⁵⁹.

In a case of hypothetical alternative causation the breach caused the loss, but the loss would have occurred even if there had been no breach. It could be illustrated by following case: the seller was obliged to put the goods on ship X, but he had breached the contract and put them on ship Y, which has sank. Then he proves that the ship X also sank, and therefore there is no breach¹⁶⁰.

156 *Ibidem*, p. 80.

157 *Ibidem*, p. 81.

158 R. Wright [after:] R. Baldwin, *A Structural Model Interpretation of Wright's NESS Test* (2003), p.3.

159 *Ibidem*, p. 82.

160 *Ibidem*, p. 85.

In various cases apart from the main cause there occurs an intervening cause, which happens after the breach, but before the loss. In effect it breaks the chain of causation. If an intervening event is considered 'much more responsible' for the loss than the first breach, it is considered unfair to hold the breaching party liable¹⁶¹. The intervening cause must be independent from the breach and be abnormal, which means that it is not an event that occurs usually.

What if it is the injured party who contributed to failure to perform of other party? The CISG provides that: „a party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission”¹⁶². If the injured party contributed itself to the loss after the breach, for example, without examination of the goods, which happen to be defective, use them to manufacture other goods. If these actions caused an additional loss, they may be regarded as failure to mitigate¹⁶³.

As it was presented the issue of causation is very complex and various theories of causation exist. They may be applied simultaneously by the court and the damages may be split between parties. It is common, because an „all-or-nothing” approach is against the spirit of the CISG¹⁶⁴. The skilled lawyer may use them for achieving the desired result of reducing or avoiding the damages of party he represents¹⁶⁵.

In Chinese law, the issue of causation is also principal factor in determining liability for breach of contract. The claimant bears the burden of proving his claim in regard to causation, as well as fault and damages, unless the law imposes a different burden of proof, e.g. under art. 4 of Supreme Court's Interpretation on Valid Evidences under Civil Law Procedure¹⁶⁶.

Chinese law does not establish a specific test for proof of causation, but the case study may give some insight into that topic. It appears that courts require the claimant to prove that the defendant's conduct was both a proximate cause and the cause in fact of the

161 *Ibidem*, p. 86.

162 Art. 80 CISG (see also: art. 7.1.2. UPICC, 8:101 PECL, 9:504 PECL)

163 D. Saidov, *op. cit.*, p. 80.

164 *Ibidem*, p. 90.

165 *Ibidem*, p. 88.

166 Ch. Lu, *A Comparative Study of Liability arising from the Carriage of Dangerous Goods between Chinese and English Law*, 2009, p. 337-338.

damages. It is not clear whether courts apply the 'but-for' test¹⁶⁷.

In *Shan Dong Wei Fang International Shipping Company Ltd. and Prosperity Ocean International Shipping Company Ltd. v. Fu Yun Iron Pyrites Company Ltd.* the claimants agreed to carry cargo from China to Korea. Due to the heavy rains the vessel sank with its cargo near Shenzhen. The bunker oil contaminated sea water. The claimants paid for clean-up operation and afterwards claimed for damages from the defendant on the basis that he had not properly disclosed the dangerous cargo. He argued that there is no direct link between the cargo and the sinking of the vessel and that the real cause was the heavy weather. The court agreed with his reasoning. This cause involves tortious liability, not the contractual one, but nevertheless, can be helpful in determining how the causation could be understood in China.

It should be kept in mind, that China is not a common law country, and the courts are not required to follow other courts decisions. Therefore, due to the lack of domestic regulation, the issue of causation may be resolved in various ways.

4.3.2. Foreseeability

Another way of limiting damages is the foreseeability rule. It has a rich history and now is applied almost worldwide. For the first time it was established in 1804 CE in art. 1150 Code Civil¹⁶⁸. Then, due to significant popularity of Napoleonic Code and its impact on codification processes in Europe, this test was introduced into many legal systems. Now in the French law its role is not considerable, because it is not applied to situations involving fraud and intentional breach (*par son dol*); there are many exceptions in detailed regulations; one could not based on it claim to *Cour de cassation* and moreover, under art. 1151 Code Civil damages only cover the direct and immediate harm¹⁶⁹. The foreseeability test plays a more significant role in common law systems. In England it was used for the first time by court in *Hadley v Baxendale* (1854). This case established the contemplation

¹⁶⁷ *Ibidem*, p. 338.

¹⁶⁸ http://www.napoleon-series.org/research/government/code/book3/c_title03.html (4.02.11)

¹⁶⁹ L. Vekas, The Foreseeability Doctrine in Contractual Damage Cases, 43 *Acta Juridica Hungarica* (2002) Nos. 1-2, s. 152.

rule, upon which party could claim not only the *damnum emergens* but also any other damages that could be reasonably foreseen at the time of signing a contract¹⁷⁰. The foreseeability test was also described by Ernst Rabel in his landmark book *Das Rechts des Warenkaufs* (1936), which was one of the sources that commissions working on model law referred to. This test was introduced into the very first projects leading to harmonize international sales law: Draft of an International Law of the Sale of Goods (1935), Draft Uniform Law on International Sales of Goods (Corporeal Moveables) (1939), Draft of a Uniform "Law on the International Sale of Goods (1963), Uniform Law on the International Sale of Goods (1964). Afterwards it became, practically not changed, a part of the art. 74 CISG:

(...) damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequences of the breach of contract.

This rule was adopted to the CISG for several reasons. Firstly, even outside the law people often judge other person's actions from the standpoint of whether he or she has foreseen the consequences, excluding or diminishing culpability of those who did not. Moreover, each of the parties should calculate its risk and potential liability. The requirement of foreseeability may therefore promote economic efficiency and enable parties to manage possible risks themselves, which would make business more secure and predictable¹⁷¹. On the other hand, there are raised opinions that test of foreseeability is ill-suited for our times, since in the era of mass transactions consequences of breach are not so extensively contemplated as they were in past. Moreover, this test is vague and allows a wide degree of judicial discretion¹⁷².

Contrary to the common law system, which apply foreseeability rule to both parties, the CISG explicitly states that only the foreseeability of party in breach has legal consequences. Furthermore, the party in breach is responsible not only for the loses it foresaw, but also for those which it ought to have foreseen. The art. 7.4.4 UPICC establish less strict rules – “foresaw or could reasonably have foreseen”. The 9:503 PECL is similar,

170 *Ibidem*, s. 154.

171 D. Saidov, *op. cit.*, p. 101-102.

172 *Ibidem*, p. 121-122.

but adds to this definition: “unless the nonperformance was intentional or grossly negligent”. The wording of these acts suggests that it is not foreseeability by reasonable man to be considered (as in, e.g. French law¹⁷³), but the foreseeability of the breaching party. The criteria of reasonability from model law could be applied to the CISG as well. Moreover, the wording of the aforementioned PECL and UPICC rules introduce stricter standard of harm being a *likely result* of non-performance instead of *possible consequence* as it is stated in the CISG¹⁷⁴. Nevertheless, using the PECL and the UPICC in interpretation of certain provisions of the CISG should not lead to a narrower interpretation¹⁷⁵.

One of the most factors of foreseeability is the knowledge of relevant facts enabling the party to foresee the result. The foreseeability should be considered 'in the light of the facts and matters of which he then knew or ought to have known' (art. 74 CISG). If party knows that the breach may cause unusual losses it should notify it to another party¹⁷⁶. The knowledge of relevant facts may, for example, concern the nature of goods. The late delivery of seasonal good, like clothes, may cause bigger losses than in the case of different goods. Moreover, some trade usages may apply. In certain branch of business also various losses may be normally considered to be foreseeable¹⁷⁷.

Courts also take in account the precision of description of circumstances of the loss. If those circumstances are described in general terms, the likelihood of considering the loss foreseeable will increase¹⁷⁸.

The CISG is not clear what exactly is to be foreseen. The only guidance that the CISG provides is the division of loss suffered and lost profits. In English law only the type of loss is to be foreseen, but in French also the extent of loss should be considered¹⁷⁹. The interpretation of the CISG is in this aspect closer to the French law. Generally, the type as well as the extent of damages should be foreseen. There are various reasons for this

173 *Ibidem*, p. 104.

174 I. Schwenzer (ed.), Schlechtriem & Schwenzer, *Commentary on the UN Convention on the International Sale of Goods (CISG)*, 3rd ed., Oxford 2010, s. 1019.

175 red. J. Felemegas, *An International Approach to the Interpretation of the United Nations Convention for the International Sale of Goods (1980) as Uniform Sales Law*, Cambridge 2007, s.469.

Contrary views presented by S.Eiselen, *Remarks on the Manner in which the UNIDROIT Principles of International Commercial Contracts May Be Used for the International Sales of Goods*, 2004.

176 D. Saidov, *op. cit.*, p. 105.

177 *Ibidem*, p. 111.

178 *Ibidem*, p. 113.

179 *Ibidem*, p. 113.

interpretation. Firstly, business person normally calculate not only the nature of loss, but also the approximate limits of financial liability, since the extent of damages are more important for their business performance. Predicting only the type still leave a big uncertainty of what the losses may look like. Secondly, the legislative history of the CISG also supports this interpretation. In 1977 draft version it was stated: „loss of such *nature* which the party in breach could not reasonably have foreseen”¹⁸⁰. Nevertheless, this draft proposition was rejected.

The losses should be foreseen at the time of the conclusion of the contract¹⁸¹, because it is the time when parties may protect themselves by raising additional contract provisions or raising the price. If some terms are left open the time of the foreseeability for the aforementioned reasons will be at the point of concretization¹⁸².

The burden of proof that certain kind and extent of harm could reasonably have been foreseen at the time of conclusion of the contract lies on the party who suffered harm. Court should not raise presumptions that harm was foreseeable, but rather the party should prove that in specific circumstances and certain business environment it was so¹⁸³.

In order to facilitate applying foreseeability test to various kinds of loss German law professors¹⁸⁴ created its typology, which could be helpful despite the fact that apart from kind of harm there are many factors that could have important influence on how the foreseeability test should be applied, e.g. late delivery of seasonal goods¹⁸⁵ or a wedding dress would inflict more damages than in cases when the time of delivery is not so important.

The distinguished types of loss are as follows¹⁸⁶:

a) Non-performance loss, which is normally claimed to be foreseeable¹⁸⁷, e.g. rational costs

180 *Ibidem*, p. 117.

181 See: BGH VIII ZR 210/78, 24.X.1979 (F.R.G.) - (<http://cisgw3.law.pace.edu/cases/791024g1.html>) oraz wyrok Wiedeńskiego Sądu Arbitrażowego z 15.06.1994 SCH-4318 (*Rolled metal sheets case*) (<http://cisgw3.law.pace.edu/cases/940615a4.html>)

182 D. Saidov, *op. cit.*, p. 119-120.

183 G. Bacher, *Remedies of the Buyer under the CISG*, Belgrade / 2008, www.szecskay.hu/dynamic/Bacher_Remedies_of_Buyer.doc

184 Cf eg Schlechtriem/P Butler, UN Law, para 303 et seq; Stoll/Gruber, 4th German edition of this work, Art 74, para 40 et seq; Staudinger/Magnus, Art 74, para 31 et seq; MünchKomm/P Huber, Art 74, para 25 et seq.

185 D. Saidov, *op. cit.*, p. 111.

186 I. Schwenzer (ed.), *op.cit.*, p. 1021-1022.

187 Austria 14 January 2002 Supreme Court (*Cooling system case*)

that would be avoided if the contract had been correctly performed¹⁸⁸; in case of late payment – costs inflicted by credits¹⁸⁹ or loss caused by changes in exchange rates¹⁹⁰. Also changes in market could be foreseeable, if they are within reasonable business risk.

b) Incidental loss, which is also foreseeable, e.g. loss inflicted by necessity of preserving delivered goods that are non-conforming with contract, costs of sending them back, costs of sending replacement goods¹⁹¹.

c) Consequential loss, e.g. loss of profit. Here the foreseeability test is of the highest relevance, because specific factors connected with business environment can have impact on the extent of loss. If goods are sold on B2B trade marketplace, profits that could be gained from resale are generally foreseeable¹⁹². Entrepreneur who is selling to another entrepreneur goods that are non-conforming with contract should foresee that buyer might be in future responsible to his buyers, even if he did not know at the time of signing the contract that the first buyer will resale the goods¹⁹³. Damages inflicted by the sold goods are also foreseeable, with exception of using the sold goods in improper way¹⁹⁴.

In China the foreseeability test (*neng yujian*) is widely used. The aforementioned features of foreseeability under the CISG generally apply to Chinese law. There is, however, no test to determine the foreseeability. Normally, courts check whether the damages are reasonable outcomes of the breach that would be foreseen at the time of contract by ordinary person in similar situation. If there are some exceptional circumstances known to the

<http://cisgw3.law.pace.edu/cases/020114a3.html>

188 OLG Köln, 8 January 1997, CISG-online 217; AG München, 23 June 1995, CISG-online 368;

189 ICC Arbitration Case No. 7531 of 1994 (*Scaffold fittings case*) <http://cisgw3.law.pace.edu/cases/947531i1.html>

190 This certain matter is disputable. According to Peter Schlechtriem loss inflicted by changes in exchange rates is always foreseeable. On the other hand, in the opinion of Hungarian professors (*Sándor/Vékás*) it depends on currency. If the price is fixed in domestic value, damages could be claimed only if the seller knew at the time of signing the contract that the buyer would want to exchange the currency. If the price is fixed in foreign currency, the buyer could claim damages because it could have been foreseen by the seller that changes in exchange rates could occur.

G. Bacher, *Remedies of the Buyer under the CISG*, Belgrade / 2008,
www.szecskay.hu/dynamic/Bacher_Remedies_of_Buyer.doc

191 I. Schwenzer, Ch. Fountoulakis, *op. cit.*, p. 522.

192 *Delchi Carrier SpA v Rotorex Corp*, US Ct App (2nd Cir), 6 December 1995, CISG-online 140; OGH, 6 February 1996, CISG-online 224;

193 Germany 21 May 1996 Appellate Court Köln (*Used car case*) <http://cisgw3.law.pace.edu/cases/960521g1.html>

194 Int Ct Russian CCI, 23 December 2004, CISG-online 1188; but see CIETAC, 29 September 2004, CISG-online 1600 (contract penalties unforeseeable because they were incurred by trading company entrusting buyer to conclude sales contract with seller and respective contracts were only concluded after conclusion of contract between seller and buyer); see LG Hamburg, 21 December 2001, CISG-online 1092 for a case where contract penalties, though considered foreseeable in general, were unforeseeable due to the clause in the buyer's contract being too disadvantageous to him.

parties, more damages could be awarded¹⁹⁵.

The foreseeability test had been used frequently by Chinese courts. For example, seller should notify a possible resale¹⁹⁶, fluctuation of the prices must be taken into consideration¹⁹⁷, 'the [Seller] could not foresee cost for issuance of the L/C and the loss of interest on the deposit for issuance of the L/C'¹⁹⁸. In another case regarding loss of profit court stated that: '[Buyer] has not provided the facts and the legal basis to prove the loss of profits, RMB 20 million. Under ordinary circumstances, loss of profits shall be foreseen or ought to be foreseen by the parties when signing the contract, but [Buyer] has not proved this. Thus, the Arbitration Tribunal cannot support [Buyer]'s claim for the loss of profits, RMB 20 million'¹⁹⁹.

4.3.3. Mitigation

The CISG states in art. 77 that: „a party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated”²⁰⁰. So, the damages may be reduced to the extent that the loss could have been mitigated by the injured party, because loss that is reasonably avoidable may not be considered as having been caused by the party's breach.

The mitigation rule promotes economic efficiency and helps to prevent waste of resources in society by obligating party to reduce the waste. For example, if the buyer does not accept the delivery of perishable goods, waste will occur if the seller does not make a subsale contract on these goods. Moreover, the mitigation rule is in line with fair dealing

195 M. Zhang, *op. cit.*, p. 307.

196 China 8 March 1996 CIETAC Arbitration proceeding (Old boxboard corrugated cartons case)
<http://cisgw3.law.pace.edu/cases/960308c1.html>

197 China 12 January 1996 CIETAC Arbitration proceeding (Scrap copper case)
<http://cisgw3.law.pace.edu/cases/960112c1.html>

198 China 28 April 1995 CIETAC Arbitration proceeding (Rolled wire rod coil case)
<http://cisgw3.law.pace.edu/cases/950428c1.html>

199 China 19 September 1994 CIETAC Arbitration proceeding (Steel case)
<http://cisgw3.law.pace.edu/cases/940919c1.html>

200 See also: 7.4.8(1) UPICC, 9:505(1) PECL

and good faith principles²⁰¹. For those reasons, it is claimed to be one of the cornerstones of modern *lex mercatoria*²⁰².

Despite the fact that the term 'duty to mitigate' is commonly used, mitigation is not enforceable and no liability will be laid for those who fail to mitigate²⁰³. Nevertheless, contrary to English common law and the PECL rules, it is claimed to be a legal duty²⁰⁴. The difference lies in the wording of those legal acts. Art. 77 CISG states that party "must" take certain measures to mitigate damages, whereas art. 9:505 PECL only states that: "the non performing party is not liable for loss suffered (...) to the extent that the aggrieved party could have reduced". On the other hand, some scholars suggest that the wording in this case do not create any legal obligation²⁰⁵. From the practical point of view this matter lacks significance, because no matter whether it is a legal duty or not, it is not enforceable and the only legal sanction is subtraction from the amount of damages awarded the sum of damages that could be mitigated.

The party is required only to take those measures that are reasonable and in reasonable time. The criteria of reasonability vary *a casu ad casum*. Some guidances are however quite common, for example, the two month time for mitigation would be in most circumstances regarded as unreasonable²⁰⁶. The nature and extent of risk involved in mitigation actions would be taken into consideration by court. The most typical way to mitigate as for sale transactions is reselling goods by making a substitute transaction. The injured party is expected to make resale at the highest price reasonably possible or a cover purchase at the lowest price reasonably possible²⁰⁷. Particular factors should be taken into consideration. If, for example, clothing manufacturer fails to deliver good on time, there possibilities of mitigation are very limited if the failure occurs at the end of season²⁰⁸. In

201 D. Saidov, *op. cit.*, p. 126-128.

202 M. Mustill, *The New Lex Mercatoria: The First Twenty-five Years*, *Arb.Int'l* 1988, s. 115.

203 *Ibidem*, p. 130.

204 B. Zeller, *Comparison between the provisions of the CISG on mitigation of losses (Art. 77) and the counterpart provisions of PECL (Art. 9:505)*, <http://www.cisg.law.pace.edu/cisg/biblio/zeller77.html> (access: 1.04.11)

205 E. Opie, *Commentary on the manner in which the UNIDROIT Principles may be used to interpret or supplement Article 77 of the CISG* <http://www.cisg.law.pace.edu/cisg/principles/uni77.html>

206 L. DiMatteo et. al., *op. cit.*, p. 157.

207 D. Saidov, *op. cit.*, p. 133.

208 Germany 15 September 1994 District Court Berlin (Shoes case)
<http://cisgw3.law.pace.edu/cases/940915g1.html>

other case, if goods are produced specifically for the buyer it may be impossible to resell them if the buyer will not accept delivery²⁰⁹. As for cases involving lost profit, if the buyer accepts defective goods that were bought for resale, it may be reasonable to cure them²¹⁰.

Taking mitigation measures may incur some costs like those arising from concluding a substitute contract or curing goods. They are normally recoverable, because the principle of full compensation applies. The UPICC also provides an explicit rule in art. 7.4.8. (2): „the aggravated party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm. Similar provision is included in art. 9:505 (2) PECL. Nevertheless, the mitigation actions could not be a burden for the injured party. The injured buyer could not be required, for example, to renegotiate contracts with its subbuyers²¹¹. The balance between the injured party's legitimate interests and the duty to mitigate should not be disturbed.

Mitigation rule is strongly connected with the calculation of damages, because damages that should be mitigated or reduced would not be calculated. Mitigation rule is based on the parties' actual conduct so it is in line with the so-called 'concrete' approach of calculating damages²¹² which would be presented in following chapters. In practice, firstly the whole sum of damages would be calculated. Then from it the amount of damages that could be mitigated would be subtracted. Only the damages resulting from situations described in articles 45(1)(b), 61(1)(b) and 72 could be subtracted from the whole sum of damages²¹³. During the drafting process Prof. Honnold suggested that the mitigation rule should apply to "any other breach", but his proposal was overruled²¹⁴. Therefore the mitigation rule would not apply to reduction of price (art. 50 CISG) and claim to pay the price (art. 62)²¹⁵. After subtracting damages that could be mitigated or could be mitigated in greater extent, any additional costs of mitigating them would be added. The final result

209 Switzerland 3 December 2002 Commercial Court St. Gallen (Sizing machine case)

<http://cisgw3.law.pace.edu/cases/021203s1.html>

210 China 31 January 2000 CIETAC Arbitration proceeding (Clothes case)

<http://cisgw3.law.pace.edu/cases/000131c1.html>

211 D. Saidov, *op. cit.*, p. 142.

212 *Ibidem*, p. 144.

213 <http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-77.html> (access: 1.04.11)

214 LEGISLATIVE HISTORY 1980 Vienna Diplomatic Conference, *Summary Records of Meetings of the First Committee*, 30th meeting (<http://www.cisg.law.pace.edu/cisg/text/link77.html>)

215 GUIDE TO CISG ARTICLE 77, Secretariat Commentary <http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-77.html>

would be the damages awarded. Despite the fact, than most of the influential interpretation of mitigation principle indicate that the whole amount of damages that could be mitigated is subtracted from the damaged suffered, in few cases court subtract only half of the damages that could be mitigated, e.g. the award of Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry²¹⁶. This way of incorrect interpretation of the CISG principles is close to common law.

The burden of proof lies on the party in breach. It has to present the specific measures the injured party should have taken. If the injured party has taken other measures, the breaching party may prove that they were unreasonable²¹⁷.

Additionally to the aforementioned features of mitigation rule (*jianqing*) under the Chinese Contract Law mitigation duty is a fault-based duty. As it was mentioned before, the CISG is based on strict liability, whereas Chinese Contract Law on mixture of strict and fault liability. Therefore, if a party fails to take proper mitigation actions, it will be found at fault²¹⁸.

The analysis of cases decided by Chinese courts shows a variety of methods of mitigation, for example: kind preservation of the goods²¹⁹, cooperative reparation²²⁰, prompt resale²²¹, timely substitute purchase²²², destroying goods to prevent storage fees²²³.

4.4. Standards of proving loss

Before the damages could be awarded the loss should be proved. The UPICC in art. 7.4.3(1) states that the losses should be proved with 'reasonable degree of certainty'. Since the CISG contains no similar provision to those of the UPICC it may be stated that this

217 *Ibidem*, p. 147.

216 Russia 24 January 2000 Arbitration proceeding 54/1999 <http://cisgw3.law.pace.edu/cases/000124r1.html>

218 M. Zhang, *op. cit.*, p. 912.

219 China 6 June 1991 CIETAC-Shenzhen Arbitration (Cysteine Monohydrate case)
<http://cisgw3.law.pace.edu/cases/910606c1.html>

220 30.01.10, CIETAC (Clothes case)

221 China 25 November 1996 CIETAC Arbitration proceeding (Chromium ore case)
<http://cisgw3.law.pace.edu/cases/961125c1.html>

222 China 27 April 2000 CIETAC Arbitration Proceeding (Wool case)
<http://cisgw3.law.pace.edu/cases/000427c1.html>

223 CISG provides general duty to preserve goods. In some circumstances the goods may be sold or even destroyed.
10.0904 High People's Court (WS China Import GmbH v. Longkou Guangyuan Food Company)

matter is not ruled by CISG and it should be ruled by law applicable by virtue of private international law as it was stated by District Court Sissach (summer clothes collection case)²²⁴. The main reason to exclude proving loss issue from the scope of the CISG is regarding it as a procedural matter. However, prof. Schlechtriem takes less strict approach: 'the CISG may indirectly govern procedural matters'²²⁵. It is still under discussion whether standards of proving loss are procedural law or substantive law as in UPICC and, for example, US Restatement II²²⁶. Nevertheless, standards of proving loss should be governed by the CISG, because art. 74 requires injured party to prove the loss and this action is an integral part of exercising the right to damages.

Proving loss of profit is much more difficult than proving loss suffered. It requires inquiry into a hypothetical future or past and generally could not be proven with absolute certainty²²⁷. Still the criteria for 'reasonable certainty' apply.

Proving loss of volume is one of the most difficult types of loss of profits to be proved²²⁸. The seller has to prove that its capacity exceeds the demand for the goods and that even if the buyer had performed the contract, it would have been able to sell more goods than it did due to the breach. Moreover, he has to prove that the additional sale would have been profitable. Even more difficult is proving a loss of profit in long-term contracts, because it requires inquiry into future price levels, demand for goods, state of competition; buyer's past business experiences²²⁹. The loss of profit is relatively easy to prove in cases of sub-sale contract. When the buyer, for example, accepts non-conforming goods and sells them at lower price than initially planned, the lost profit is easy to be proven and calculated. The seller just has to prove that if there would be no breach, he would have sold the goods for higher price.

Once the loss is proved and the relevant price is known, loss of profit can be easily established with 'reasonable certainty', because it can be calculated as the difference

224 Switzerland 5 October 1999 Appellate Court Basel (Summer cloth collection case)
<http://cisgw3.law.pace.edu/cases/991005s1.html>

225 P. Schlechtriem [after:] D. Saidov, *op. cit.*, p. 164.

226 *Ibidem*, p. 165.

227 *Ibidem*, p. 154.

228 *Ibidem*, p. 158.

229 *Ibidem*, p. 160.

between the contract price and the resale or market price²³⁰.

The CCL do not provide any specific regulation on proving loss, nor does the Civil Procedure Law of the PRC. The decision whether the loss is proved or not therefore lies in the wide sphere of discretion of a judge.

4.5. Calculation of damages

The losses awarded to party must be put into a monetary terms. There are two basic methods of calculating damages: 'concrete method' and 'abstract method'.

First of them, relies on the actual circumstances. Under art. 75 CISG the amount of money is calculated as the difference between the contract price and the price in a transaction which is found to be a true substitute plus some additional costs like costs of storage, care between breach and resale²³¹. Three elements are required: avoidance of contract, reasonable substitute transaction (which is closely linked with the duty to mitigate) and making the cover purchase in reasonable time²³². Whether the claim under the 'concrete formula' may include the damages from loss of profit is still the subject of debate. The predominant opinion is opposed including loss of profit, because on the substitute sale the buyer is intended to make profit²³³.

The abstract method, established by art. 76 CISG, regards the difference between the contract price and the 'current price' at the time of avoidance of contract. It is applied when the contract has been avoided, but there was no substitute transaction. Additionally, it could be applied only if there is a 'current price' for goods²³⁴.

The current price may be defined as a 'price prevailing at the place where delivery of the goods should have been made'²³⁵. If there is no current price at the place of delivery, other proximate place is being chosen as the substitute. In some cases an international market price is applied²³⁶. It may be worth noticing, that even the price from 'black market'

230 *Ibidem*, p. 158.

231 *Ibidem*, p. 186.

232 P. Huber, A. Mullis, *op. cit.*, p. 284-286.

233 *Ibidem*, p. 287.

234 *Ibidem*, p. 287.

235 D. Saidov, *op. cit.*, p. 199.

236 *Ibidem*, p. 205.

could be recognized as a 'current price'²³⁷.

The CISG prefers the concrete method and the abstract one is used only if no substitute transaction has been made. Abstract formula is an alternative, not a supplement to concrete formula. Where there is no avoidance of contract the general provisions of full compensation apply. They apply also to the lost profits.

In Chinese law, the issue of calculation of damages is regulated by art. 113 CCL:

Where a party failed to perform or rendered non-conforming performance, thereby causing loss to the other party, the amount of damages payable shall be equivalent to the other party's loss resulting from the breach, including any benefit that may be accrued from performance of the contract, provided that the amount shall not exceed the likely loss resulting from the breach which was foreseen or should have been foreseen by the breaching party at the time of conclusion of the contract.

Where a merchant engages in any fraudulent activity while supplying goods or services to a consumer, it is liable for damages in accordance with the Law of the People's Republic of China on Protection of Consumer Rights.

The provisions of the CCL do not provide any specific formula of calculation of damages, as the 'abstract' and 'concrete formula' under the CISG. Therefore, only a general principle of full compensation applies.

There are, however, some specific regulations regarding damages in case of loss of cargo established by art. 312 CCL. Under this article, if the amount of damages was not prescribed, it shall be calculated based on the prevailing market price at the destination when the cargo was or should have been delivered. Moreover, if a law or administrative regulation provides otherwise in respect of the method for calculation of damages and any limitation on damages, such provisions apply.

²³⁷ *Ibidem*, p. 202.

5. The application of the CISG in China

5.1. The CIETAC's decisions regarding art. 74 CISG

After analyzing the influence of the CISG on the PRC legislation, the application of the CISG in China would be presented. In following chapter various court decisions would be examined to explain how the CISG law of damages, mainly art. 74 CISG, is employed by Chinese courts.

All the cases that would be analyzed are decisions made by the China International Economic and Trade Arbitration Commission (CIETAC) – *Zhongguo guoji jingji maoyi zhongcaiweiyuanhui*. The CIETAC cases were chosen by the author because of various reasons. Firstly, the CIETAC, founded in 1956²³⁸ (on this time functioning under the name: Foreign Trade Arbitration Commission) is one of the oldest and the largest arbitrary institutions in Asia. From 2000 till 2005 the CIETAC caseload was respectively: 543, 731, 684,709, 850, 979. It was in 2005 the first world arbitration court in terms of caseload²³⁹. The significant growth of caseload was probably connected with China entry to WT in 2001. Along with the growth of caseload the number of arbitrators grew. In 1956 there were only 21 listed arbitrators, all of them were Chinese nationals. This number increased to 65 in 1980, 71 in 1983, 291 in mid-1990s and 428 (including 147 foreign nationals) at the end of the 1990s²⁴⁰. The CIETAC has its offices in many places in China: in 1989-1990 it established its Shenzhen Sub-Commission and Shanghai Sub-Commission and five offices in Chongqing, Chengdu, Changsha, Fuzhou and Dalian²⁴¹.

Secondly, the Chinese case recording system (www.chinacourt.org) is still infantile. There is a vast difference between English and Chinese version. Case notes are far from Western standards and they are rather similar to newspapers articles²⁴². Last but not least,

238 <http://www.cietac.org/>

239 F. Yang, *op. cit.*, p. 18.

240 B. Liang, *The Changing Chinese Legal System, 1978-Present: Centralization of Power and Rationalization of Legal System*, New York 2008, p. 141.

241 L. Hu, *Introduction to commercial arbitration in China*, p. 3.

242 G. Li, The PRC Contract Law and Its Unique Notion of Subrogation, *Journal of International Commercial Law and Technology*, vol. 4 issue 1 (2009), p.15.

both foreign and Chinese clients preferred arbitrators to hear their disputes since arbitration, compared with judicial means is more flexible²⁴³. Foreign parties also prefer arbitration to Chinese regular court system.

For this reasons, majority of Chinese arbitral awards involving the CISG is made mainly by the CIETAC²⁴⁴. Up to 2008 it has published three volumes of compilation of arbitral awards regarding sales of goods and foreign investments. The books consist of 337 arbitral awards out of which 160 has been made after 1988. No regular reports have ever been presented on how often the CISG was applied because arbitration cases are confidential. However, it was said by the CIETAC that Sales of Goods reached 40-50% (1990-1994) or even more (1997) of their annual disputes²⁴⁵.

The CIETAC plays an active role in expanding the influence of the CISG in China. It facilitated arbitrators, attorneys-at-law and contracting parties to grasp the particular meaning of the CISG. A study of the CIETAC decisions may illustrate integration of international law into China's legal framework.

The CIETAC's decision may provide insight into application of certain aspect of the CISG in regard to damages. The loss of profit issue is one of the most disputable category of damages in China and therefore would be presented more broadly. As it has been proved in previous chapters, there is no facile way to estimate the loss of profit. Therefore, it is no surprise that the CIETAC's decisions in which court awards damages from loss of profit varies significantly. In their research Sharon G. K. Singh and Bruno Zeller had distinguished eight broad categories of the CIETAC decisions concerning loss profits²⁴⁶. Generally each of them is in line with the CISG general principles and art. 74, 75, 76 CISG, which are the most important articles for the aggrieved party to rely on.

(1) seller's lost profits calculated as the difference between the contract price and the actual production cost of the goods as, e.g. in *Semi-Automatic Weapons Case*²⁴⁷;

(2) the difference between the contract price between the seller and the buyer and the

243 D. Ding, *op. cit.*, p. 31.

244 F. Yang, *op. cit.*, p. 19.

245 D. Ding, *op. cit.*, p. 32.

246 S. Singh, B. Zeller, *op. cit.*, p.217-218.

247 China 7 August 1993 CIETAC Arbitration proceeding (Semi-automatic weapons case),

<http://cisgw3.law.pace.edu/cases/930807c1.html>

contract price between the seller's supplier and the seller as in, e.g. *Hot-Rolled Steel Case* (1996)²⁴⁸;

(3) the price difference between the contract price and the price of actual resale as in, e.g. *Chrome-plating machines production-line equipment case* (1996)²⁴⁹;

(4) the buyer's lost profits calculated as his anticipated net profits (anticipated gross profits minus fees payable) as in, e.g. *Tin Plate Case* (1996)²⁵⁰;

(5) the price difference between the contract price and the price of the intended resale to subbuyer (minus costs of resale) as in, e.g. *Palm Oil Case* (1996)²⁵¹;

(6) the difference between the prices of the intended resale to sub-buyer and the actual resale made as in, e.g. *Old Corrugated Carton Case* (1996)²⁵²;

(7) the price difference according to the calculations set out in Article 76 as in, e.g. *Steel Case* (1994)²⁵³;

(8) the awarding loss profits as well as price difference under Article 75 or 76 and associated calculations to either party as in, e.g. *Cotton Bath Towel Case* (1996)²⁵⁴.

The above-mentioned cases reveal that the application of art. 74 CISG with regard to loss of profit in late 90's was very inconsistent. Now the courts are getting more experience in using the CISG and the judgments and arbitration awards are more in line with the international interpretation of CISG. Nevertheless, some problems still remain.

5.2. Problems with application of the CISG in China

The application of CISG provisions in China faces several problems from with two

248 China 10 May 1996 CIETAC Arbitration proceeding (Hot-rolled steel plates case)

<http://cisgw3.law.pace.edu/cases/960510c1.html>

249 China 12 July 1996 CIETAC Arbitration proceeding (Chrome-plating machines production-line equipment case)

<http://cisgw3.law.pace.edu/cases/960712c1.html>

250 China 17 October 1996 CIETAC Arbitration proceeding (Tinplate case)

<http://cisgw3.law.pace.edu/cases/961017c1.html>

251 China 22 January 1996 CIETAC Arbitration proceeding (Palm oil case)

<http://cisgw3.law.pace.edu/cases/960122c1.html>

252 China 8 March 1996 CIETAC Arbitration proceeding (Old boxboard corrugated cartons case)

<http://cisgw3.law.pace.edu/cases/960308c1>

253 China 19 September 1994 CIETAC Arbitration proceeding (Steel case)

<http://cisgw3.law.pace.edu/cases/940919c1.html>

254 China 26 October 1996 CIETAC Arbitration proceeding (Cotton bath towel case)

<http://cisgw3.law.pace.edu/cases/961026c1.html>

most important are: the incorrect application of general principles and the ethnocentric approach. Those errors in application of CISG refer not only to damages, but also to the remaining substantive issues regulated by CISG. This chapter will however be limited to the cases involving damages.

5.2.1. Incorrect application of general principles

The fact that the CISG has general principles is in various decisions ignored. The CISG was not intended to be complete and there are gaps within its regulation²⁵⁵. They should be filled firstly by general principles. Those principles are said to be the 'glue' giving cohesiveness to the CISG²⁵⁶. Only if none of them apply, then recourse to applicable domestic law is possible. Moreover, the CISG provisions should be interpreted in the light of general principles. Nevertheless, in the CIETAC's decisions single articles are sometimes applied in isolation without due consideration to general principles²⁵⁷ and art. 7 CISG, which is a cornerstone of the Convention.

Apart from not giving due consideration to general principles, they are in various cases misunderstood or applied incorrectly.

In the *Equipment Case* CIETAC court stated that:

[Buyer] accepted [Seller]'s claim for US \$37,260.75 when negotiating with [Seller], but [Seller] at the same time, claimed for damages in connection with a signed but not effective contract with another company, with the result that the dispute could not be resolved on time; it is therefore unreasonable to calculate interest for such a long time. Also, there is no basis for an interest rate of 13%²⁵⁸.

In other words, court rejected the calculation of United States seller on the basis that the profit to made was unreasonable. It should be strongly stated that the CISG do not apply reasonableness test to the damages. They must be foreseeable in „light of the facts and matters of which he then knew or ought to have known as a possible consequence of the

255 B. Zeller, The Challenge of a uniform application of the CISG – Common Problems and their Solutions, *Macquarie Journal of Business Law* vol 3 (2006), p. 310.

256 *Ibidem*, p. 314.

257 *Ibidem*, p. 309.

258 China 20 December 1993 CIETAC Arbitration proceeding (Equipment Case)
<http://cisgw3.law.pace.edu/cases/931220c1.html>

breach of contract” (art. 74 CISG). Applying reasonability test to calculation of lost profit damages limited them in unjust way.

In *Clothes case* the „reasonability” was used in court decision to explain the calculation of damages without presenting any academic reasoning. What for the court was 'reasonable' was an arbitrary figure²⁵⁹. “The [Seller] shall pay the [Buyer] the loss of profit resulting from the defective goods, and the reasonable amount shall be 20% of the contract price.”²⁶⁰

5.2.2. Ethnocentric approach

Even when outward uniformity is achieved, (...) uniform application of the agreed rules is by no means guaranteed, as in practice different countries almost inevitably come to put different interpretations upon the same enacted words²⁶¹.

The second major problem of the CISG application in an ethnocentric approach. The quotation above reveal the concern that legal and cultural differences will necessarily be revealed in courts and would affect the interpretation of international legal acts. Truly, as Professor Gerhard Kegel said, the most troublesome for international private law is nothing else but domestic law²⁶². The problems that the application of international conventions faces in this regard are numerous.

Firstly, the domestic law is sometimes regarded as an „embodiment of everything which is excellent”²⁶³. Therefore, provisions of international treaties are in some unsatisfactory court decisions interpreted in the light of domestic law. The main reason for this is that courts are more familiar with domestic law and feel with it more confident²⁶⁴. Moreover, there is no uniform supreme court guarding interpretation of the CISG. The right interpretation however could be ensured by numerous materials and cases published on the CISG-related websites²⁶⁵.

259 S. Singh, B. Zeller, *op. cit.*, p.232.

260 31.01.2000 CIETAC (*Clothes case*)

261 R.J.C. Munday, *The Uniform Interpretation of International Conventions*, 27 *Int'l & Comp. L.Q.* 450 (1978).

262 B.Fuchs, *op. cit.*, p.13-14.

263 R. Tokarczyk, *Wprowadzenie do komparatystki prawniczej* (1996), p. 14.

264 Y. Xiao, W. Long, *Selected Topics on the Application of the CISG in China*, p. 102.

265 I. Schwenzer, P. Hachem, *op. cit.*, p. 468.

Interpreting words in national context may lead to 'deconstruction' as Professor Honnold describes the problem²⁶⁶. 'Deconstruction' means that certain provisions would be interpreted differently in different countries, because of the references to domestic law. The drafters of CISG intentionally did not include in the final text words with national legal connotations to minimize probability of interpreting Convention's terms in the light of domestic law. Still, 'deconstruction' is a serious obstacle to uniform application of the CISG. The most quoted court decision in this matter is *Raw Materials Inc v Manfred Forberich GmbH*, called the worst CISG decision in 25 year, because of the wrong interpretation of the CISG terms²⁶⁷.

In China, this problem may occur, because the domestic law is similar to to the CISG. The legal culture is still relatively law and there is a serious risk that the CISG would be interpreted in the same manner as the CCL. The CCL is interpreted in a context of whole legal system of China, and on the other hand the CISG interpretation should be autonomous. If the similar provisions of the CCL and the CISG would be interpreted in the same matter, no problem would occur. But, if the CCL would be interpreted differently, it may be so that the courts would interpret the CISG in the same manner, because the CCL would be better know to them.

Secondly, which is even more characteristic for the CIETAC's decisions, in various cases, in which the CISG should be applied, the Chinese Contract Law was applied, the CISG and the CCL were applied simultaneously²⁶⁸ or the question of applicable law was not even raised. Survey made by prof. Wei Li showed that out of 160 aforementioned CIETAC arbitral awards, 98 indicate no formal opinion on the law applicable²⁶⁹. The Chinese law was applied automatically. As an example may serve *China XX Company v. German XX Company (Vitamin C case)*²⁷⁰. Both parties of the contract had place of business in a Contracting States, there was no agreement on the applicable law and the contract was a sale of goods contract. Therefore, the CISG should automatically apply, but the question of

266 J. Honnold, Uniform Laws for International Trade: Early "Care and Feeding" for Uniform Growth, *International Trade and Business Law Journal* (1995), p. 3.

267 B. Zeller, *The Challenge of a uniform application of the CISG*, p. 311.

268 Y. Xiao, W. Long, *op. cit.*, p. 101.

269 L. Wei, *The Interpretation of the CISG in China*, (2008), p. 344.

270 CIETAC, *The Compilation of Arbitral Awards on China International Economy and Trade* (volume on sales of goods 1995-2002), p. 192-195.

applicability of the CISG was not even raised by the CIETAC and the Chinese law was applied.

On the other hand, in some cases the CISG is applied without any inquiry²⁷¹, even when in some situations the application of the CISG would seem to be not so right in theory as in Cold rolled steel plates case²⁷². The CISG was applied between Hong Kong and PRC parties, where no law applicable was chosen. The court applied the CISG 'naturally' without examining the conflict of law issue. In another case, the *Nanjing Resources Group v. Tian An Insurance Co. Ltd. Nanjing Branch* court concluded that the CISG will apply because 'the international maritime transportation insurance contract is related to the international contract for the sale of goods, so the relevant law or convention governing international sales of goods, i.e., the CISG and the INCOTERMS 1990 shall apply to this case'²⁷³.

The court had not investigated whether the parties (PRC and Japanese) places of business are in contracting states. In fact, Japan acceded the CISG on 1st July 2008, six years after the case was recognized. In *Cement case* between a PRC seller and a Hong Kong buyer where no applicable law was chosen, court decided that the PRC law was applicable 'in light of CISG'²⁷⁴. The court applied some provisions from Chinese law and some from the CISG. It should be mentioned that wrong application of conventions or domestic law is also a common problem in IP cases²⁷⁵ and cases involving ecological treaties²⁷⁶.

The criticism should be laid on the early CIETAC's decisions. Through years decisions have become more consistent with international interpretation²⁷⁷. It may correspond with introduction of the CCL with shares the common spirit with the CISG and facilitates the good understanding of the CISG by Chinese judges.

271 F. Yang, *op. cit.*, p. 27.

272 See: China 30.07.1998 CIETAC Arbitration Proceeding (Cold rolled steel plates case)

<http://cisgw3.law.pace.edu/cases/980730c1.html>

273 China 10.09.02, Wuhan Maritime Court, *Nanjing Resources Group v. Tian An Insurance Co. Ltd. Nanjing Branch*;

<http://cisgw3.law.pace.edu/cases/020910c1.html>

274 China 26.03.1993 CIETAC Arbitration proceeding (Cement case): <http://cisgw3.law.pace.edu/cases/930326c1.html>

275 A.K. Sanders, Intellectual property law and policy and economic development with special reference to China [in:] *Economic Analysis of Law in China*, ed. T. Eger, M. Faure, N. Zhang (2007), p. 252.

276 M. Faure, W. Hu, Economic analysis of compensation for oil pollution damage in China [in:] *Economic Analysis of Law in China*, ed. T. Eger, M. Faure, N. Zhang, (2007), p. 280.

277 S. Singh, B. Zeller, *op. cit.*, p. 230.

6. Concluding remarks

The development of contract law and practice in the People's Republic of China illustrates the process of adaptation of foreign legal models, especially the CISG and *lex mercatoria*. However, this adaptation is very selective.

With regard to breach of contract, the unitary concept of breach was introduced as early as in 1985 under the Foreign Economic Law and remained in the Chinese Contract Law (1999), which became effective, when the FCL was abrogated. Nevertheless, the character of the breach is unclear, because the CCL do not indicate whether it is based on fault or not. Due to the lack of regulation, the General Principles of Civil Law (1986) should apply. Under this legal act the breach of contract is fault-based. This matter is however very controversial and many different views are raised. The Civil Code, which is being drafted and is supposed to be enacted in 2013, would cover the regulations of the CCL and the GPCL and unify those acts. Under this code, the strict-liability principle in regard to the breach of contract should be introduced, so it would be in line with others provisions of the CCL and the trends of modern contract law.

As for the damages, which are in China the most often awarded remedies, both the CISG and the CCL stand for the full compensation principle. However, the CCL also provides three different types of damages apart from the compensatory one: liquidated damages, punitive damages, earnest money. The punitive character of damages, that was embodied in the early civil law act of PRC, still remains, however its extent is very narrow. The punitive damages are awarded mostly with regard to consumer sales. There is also a difference between the anticipatory breach regulation in the CISG and in the CCL. Under the latter, when party expressly stated or indicated by its conduct that it will not perform its main obligations, the other party may terminate the contract, not suspend its performance as provided by the CISG. The concept of fundamental breach was not introduced into Chinese law.

In regard to general influence of the CISG on the CCL there are numerous common provisions, e.g. principles of autonomy, binding character of contract, good faith, formation of contract: offer and acceptance, authority of agents. Nevertheless, lawyers should not be

lulled into a false complacency. On the surface, the CCL appears to be very similar to the CISG, but closer examination, however, reveals significant differences that can alter agreements and thwart the intentions of contracting parties.

Despite acknowledging the principle of freedom of contracts, the CCL still provides some restrictions to it. Contract could be void if they infringe the good faith or the social public morality. Especially the second prerequisite could be overused by Chinese authorities. As for requirement of a written form of contract it is not provided by the CISG nor by the CCL. Nevertheless, China has made a reservation under art. 96 opting-out the art. 11 regarding freedom of form. Therefore, China should remove its reservation in order to provide unitary standard for both international and domestic contracts. Moreover, the CCL contains some provisions that reflect more the state-planned economy than the capitalist one, e.g. under the gap-filling provisions in case of lack of parties decisions as for the price or quality the government mandated price or state standard of quality would be introduced into contract. Nevertheless, despite the aforementioned differences, it could be stated that the CCL shares the spirit of the Convention.

Apart from analysis of law in books some remarks of its application should be made. Majority of the court decisions involving the CISG is made by arbitration courts, especially the CIETAC. In the early CIETAC's decisions the CISG was often wrongly applied and interpreted. The most significant problems of application the CISG in China were incorrect application of general principles and art. 7 CISG and an ethnocentric approach. Nevertheless, the Chinese domestic law has changed significantly during the last years, especially in the beginning of Reform and Opening-up period in 1978 and in 1999, when the Chinese Contract Law was enacted. Due to the fact that the CCL shares many CISG provisions, Chinese judges understand the latter more, because they are able to draw, in essence, on the same principles.

The harmonization of the Chinese law with the international legal standards established by the CISG was relatively easy, because due to the legal nihilism of Mao era, there was no competitive law of contracts. China has one of the oldest, basically uninterrupted legal culture, but it was mainly concerned with penal and administrative law. The contract law was not codified before 1929-1930. Moreover, under the Communist reign

the law was only an instrument of Chinese Communist Party's control over society. Therefore, when after Deng Xiaoping proclamation of start of Reforms and Opening-up in 1978 China began to build anew its legal system it could draw from the most sophisticated legal acts available, the CISG and *lex mercatoria*. A very modern system of law was created, that includes even the comprehensive regulation of contracts made through internet. When the Chinese judges would gain more experience and become more independent, the Chinese legal system would be more creditworthy. For now, the harmonization helps in decreasing the transaction costs of cross border contracts, which would be significantly greater if Chinese domestic legal system was very different from the international uniform instruments. Moreover, the understanding of the CISG will be helpful for business person in understanding the fundamentals of the Chinese Contract Law. Therefore, harmonization leads to ascertaining more legal predictability and increasing economic efficiency.

Appendix: Selected articles of the Chinese Contract Law: General Principles, Liability for Breach, Sales Contract

General Principles

Article 1 Purpose

This Law is formulated in order to protect the lawful rights and interests of contract parties, to safeguard social and economic order, and to promote socialist modernization.

Article 2 Definition of Contract; Exclusions

For purposes of this Law, a contract is an agreement between natural persons, legal persons or other organizations with equal standing, for the purpose of establishing, altering, or discharging a relationship of civil rights and obligations. An agreement concerning any personal relationship such as marriage, adoption, guardianship, etc. shall be governed by other applicable laws.

Article 3 Equal Standing of Parties

Contract parties enjoy equal legal standing and neither party may impose its will on the other party.

Article 4 Right to Enter into Contract Voluntarily

A party is entitled to enter into a contract voluntarily under the law, and no entity or individual may unlawfully interfere with such right.

Article 5 Fairness

The parties shall abide by the principle of fairness in prescribing their respective rights and obligations.

Article 6 Good Faith

The parties shall abide by the principle of good faith in exercising their rights and performing their obligations.

Article 7 Legality

In concluding or performing a contract, the parties shall abide by the relevant laws and administrative regulations, as well as observe social ethics, and may not disrupt social and economic order or harm the public interests.

Article 8 Binding Effect; Legal Protection

A lawfully formed contract is legally binding on the parties. The parties shall perform their respective obligations in accordance with the contract, and neither party may arbitrarily amend or terminate the contract.
A lawfully formed contract is protected by law.

Article 9 Capacity; Contract through Agent

In entering into a contract, the parties shall have the appropriate capacities for civil rights and civil acts.
A party may appoint an agent to enter into a contract on its behalf under the law.

Article 10 Forms of Contract; Writing Requirement

A contract may be made in a writing, in an oral conversation, as well as in any other form.
A contract shall be in writing if a relevant law or administrative regulation so requires. A contract shall be in writing if the parties have so agreed.

Article 11 Definition of Writing

A writing means a memorandum of contract, letter or electronic message (including telegram, telex, facsimile, electronic data exchange and electronic mail), etc. which is capable of expressing its contents in a tangible form.

Article 12 Terms of Contract

The terms of a contract shall be prescribed by the parties, and generally include the following:

- (i) names of the parties and the domiciles thereof;
- (ii) subject matter;
- (iii) quantity;
- (iv) quality;
- (v) price or remuneration;
- (vi) time, place and method of performance;
- (vii) liabilities for breach of contract;
- (viii) method of dispute resolution.

The parties may enter into a contract by referencing a model contract for the relevant contract category.

Article 13 Offer-Acceptance

A contract is concluded by the exchange of an offer and an acceptance.

Article 14 Definition of Offer

An offer is a party's manifestation of intention to enter into a contract with the other party, which shall comply with the following:

- (i) Its terms are specific and definite;
- (ii) It indicates that upon acceptance by the offeree, the offeror will be bound thereby.

Article 15 Invitation to Offer

An invitation to offer is a party's manifestation of intention to invite the other party to make an offer thereto. A delivered price list, announcement of auction, call for tender, prospectus, or commercial advertisement, etc. is an invitation to offer.

A commercial advertisement is deemed an offer if its contents meet the requirements of an offer.

Article 16 Effectiveness of Offer, Offer through Electronic Message

An offer becomes effective when it reaches the offeree.

When a contract is concluded by the exchange of electronic messages, if the recipient of an electronic message has designated a specific system to receive it, the time when the electronic message enters into such specific system is deemed its time of arrival; if no specific system has been designated, the time when the electronic message first enters into any of the recipient's systems is deemed its time of arrival.

Article 17 Withdrawal of Offer

An offer may be withdrawn. The notice of withdrawal shall reach the offeree before or at the same time as the offer.

Article 18 Revocation of Offer

An offer may be revoked. The notice of revocation shall reach the offeree before it has dispatched a notice of acceptance.

Article 19 Irrevocable Offer

An offer may not be revoked:

- (i) if it expressly indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable;
- (ii) if the offeree has reason to regard the offer as irrevocable, and has undertaken preparation for performance.

Article 20 Extinguishment of Offer

An offer is extinguished in any of the following circumstances:

- (i) The notice of rejection reaches the offeror;
- (ii) The offeror lawfully revokes the offer;
- (iii) The offeree fails to dispatch its acceptance at the end of the period for acceptance;
- (iv) The offeree makes a material change to the terms of the offer.

Article 21 Definition of Acceptance

An acceptance is the offeree's manifestation of intention to assent to an offer.

Article 22 Mode of Acceptance; Acceptance by Conduct

An acceptance shall be manifested by notification, except where it may be manifested by conduct in accordance with the relevant usage or as indicated in the offer.

Article 23 Timely Dispatch of Acceptance

An acceptance shall reach the offeror within the period prescribed in the offer.

Where the offer does not prescribe a period for acceptance, the acceptance shall reach the offeror as follows:

- (i) Where the offer is made orally, the acceptance shall be dispatched immediately, unless otherwise agreed by the parties;
- (ii) Where the offer is made in a non-oral manner, the acceptance shall reach the offeror within a reasonable time.

Article 24 Commencement of the Period for Acceptance

Where an offer is made by a letter or a telegram, the period for acceptance commences on the date shown on the letter or the date on which the telegram is handed in for dispatch. If the letter does not specify a date, the period commences on the posting date stamped on the envelop. Where the offer is made through an instantaneous communication device such as telephone or facsimile, etc., the period for acceptance commences once the offer reaches the offeree.

Article 25 Contract Formed upon Effectiveness of Acceptance

A contract is formed once the acceptance becomes effective.

Article 26 Effectiveness of Acceptance

A notice of acceptance becomes effective once it reaches the offeror. Where the acceptance does not require notification, it becomes effective once an act of acceptance is performed in accordance with the relevant usage or as required by the offer.

Where a contract is concluded by the exchange of electronic messages, the time of arrival of the acceptance shall be governed by Paragraph 2 of Article 16 hereof.

Article 27 Withdrawal of Acceptance

An acceptance may be withdrawn. The notice of withdrawal shall reach the offeror before or at the same time as the acceptance.

Article 28 Late Acceptance

An acceptance dispatched by the offeree after expiration of the period for acceptance constitutes a new offer, unless the offeror timely advises the offeree that the acceptance is valid.

Article 29 Delayed Transmission of Acceptance

If the offeree dispatched its acceptance within the period for acceptance, and the acceptance, which would otherwise have reached the offeror in due time under normal circumstances, reaches the offeror after expiration of the period for acceptance due to any other reason, the acceptance is valid, unless the offeror timely advises the offeree that the acceptance has been rejected on grounds of the delay.

Article 30 Acceptance Containing Material Change

The terms of the acceptance shall be identical to those of the offer. A purported acceptance dispatched by the offeree which materially alters the terms of the offer constitutes a new offer. A change in the subject matter, quantity, quality, price or remuneration, time, place and method of performance, liabilities for breach of contract or method of dispute resolution is a material change to the terms of the offer.

Article 31 Acceptance Containing Non-material Changes

An acceptance containing nonmaterial changes to the terms of the offer is nevertheless valid and the terms thereof prevail as the terms of the contract, unless the offeror timely objects to such changes or the offer indicated that acceptance may not contain any change to the terms thereof.

Article 32 Time of Formation in Case of Memorandum of Contract

Where the parties enter into a contract by a memorandum of contract, the contract is formed when it is signed or sealed by the parties.

Article 33 Time of Formation in Case of Letters or Electronic Messages; Confirmation Letter

Where the parties enter into a contract by the exchange of letters or electronic messages, one party may require execution of a confirmation letter before the contract is formed. The contract is formed upon execution of the confirmation letter.

Article 34 Place of Formation; Electronic Messages

The place where the acceptance becomes effective is the place of formation of a contract. Where a contract is concluded by the exchange of electronic messages, the recipient's main place of business is the place of formation of the contract; if the recipient does not have a main place of business, its habitual residence is the place of formation of the contract. If the parties have agreed otherwise, such agreement prevails.

Article 35 Place of Formation in Case of Memorandum of Contract

Where a contract is concluded by a memorandum of contract, its place of formation is the place where the parties sign or seal the contract.

Article 36 Effect of Failure to Conclude Contract in Writing

Where a contract is to be concluded by a writing as required by the relevant law or administrative regulation or as agreed by the parties, if the parties failed to conclude the contract in writing but one party has performed its main obligation and the other party has accepted the performance, the contract is formed.

Article 37 Effect of Failure to Sign in Case of Memorandum of Contract

Where a contract is to be concluded by a memorandum of contract, if prior to signing or sealing of the contract, one party has performed its main obligation and the other party has accepted the performance, the contract is formed.

Article 38 Contract under State Mandatory Plan

Where the state has, in light of its requirements, issued a mandatory plan or state purchase order, the relevant legal persons and other organizations shall enter into a contract based on the rights and obligations of the parties prescribed by the relevant laws and administrative regulations.

Article 39 Standard Terms; Duty to Call Attention

Where a contract is concluded by way of standard terms, the party supplying the standard terms shall abide by the principle of fairness in prescribing the rights and obligations of the parties and shall, in a reasonable manner, call the other party's attention to the provision(s) whereby such party's liabilities are excluded or limited, and shall explain such provision(s) upon request by the other party.

Standard terms are contract provisions which were prepared in advance by a party for repeated use, and which are not negotiated with the other party in the course of concluding the contract.

Article 40 Invalidity of Certain Standard Terms

A standard term is invalid if it falls into any of the circumstances set forth in Article 52 and Article 53 hereof, or if it excludes the liabilities of the party supplying such term, increases the liabilities of the other party, or deprives the other party of any of its material rights.

Article 41 Dispute Concerning Construction of Standard Term

In case of any dispute concerning the construction of a standard term, such term shall be interpreted in accordance with common sense. If the standard term is subject to two or more interpretations, it shall be interpreted against the party supplying it. If a discrepancy exists between the standard term and a non-standard term, the non-standard term prevails.

Article 42 Pre-contract Liabilities

Where in the course of concluding a contract, a party engaged in any of the following conducts, thereby causing loss to the other party, it shall be liable for damages:

- (i) negotiating in bad faith under the pretext of concluding a contract;
- (ii) intentionally concealing a material fact relating to the conclusion of the contract or supplying false information;
- (iii) any other conduct which violates the principle of good faith.

Article 43 Trade Secrets; Liability for Disclosure or Improper Use

A party may not disclose or improperly use any trade secret which it became aware of in the course of negotiating a contract, regardless of whether a contract is formed. If the party disclosed or improperly used such trade secret, thereby causing loss to the other party, it shall be liable for damages.

Article 44 Effectiveness of Contract

A lawfully formed contract becomes effective upon its formation.

Where effectiveness of a contract is subject to any procedure such as approval or registration, etc. as required by a relevant law or administrative regulation, such provision applies.

Liability for Breach

Article 107 Types of Liabilities for Breach

If a party fails to perform its obligations under a contract, or rendered non-conforming performance, it shall bear the liabilities for breach of contract by specific performance, cure of non-conforming performance or payment of damages, etc.

Article 108 Anticipatory Breach

Where one party expressly states or indicates by its conduct that it will not perform its obligations under a contract, the other party may hold it liable for breach of contract before the time of performance.

Article 109 Monetary Specific Performance

If a party fails to pay the price or remuneration, the other party may require payment thereof.

Article 110 Non-monetary Specific Performance; Exceptions

Where a party fails to perform, or rendered non-conforming performance of, a non-monetary obligation, the other party may require performance, except where:

- (i) performance is impossible in law or in fact;
- (ii) the subject matter of the obligation does not lend itself to enforcement by specific performance or the cost of performance is excessive;
- (iii) the obligee does not require performance within a reasonable time.

Article 111 Liabilities in Case of Quality Non-compliance

Where a performance does not meet the prescribed quality requirements, the breaching party shall be liable for breach in accordance with the contract. Where the liabilities for breach were not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, the aggrieved party may, by reasonable election in light of the nature of the subject matter and the degree of loss, require the other party to assume liabilities for breach by way of repair, replacement, remaking, acceptance of returned goods, or reduction in price or remuneration, etc.

Article 112 Liability for Damages Notwithstanding Subsequent Performance or Cure of Non-conforming Performance

Where a party failed to perform or rendered non-conforming performance, if notwithstanding its subsequent performance or cure of non-conforming performance, the other party has sustained other loss, the breaching party shall pay damages.

Article 113 Calculation of Damages; Damages to Consumer

Where a party failed to perform or rendered non-conforming performance, thereby causing loss to the other party, the amount of damages payable shall be equivalent to the other party's loss resulting from the breach, including any benefit that may be accrued from performance of the contract, provided that the amount shall not exceed the likely loss resulting from the breach which was foreseen or should have been foreseen by the breaching party at the time of conclusion of the contract.

Where a merchant engages in any fraudulent activity while supplying goods or services to a consumer, it is liable for damages in accordance with the Law of the People's Republic of China on Protection of Consumer Rights.

Article 114 Liquidated Damages; Adjustment; Continuing Performance Notwithstanding Payment of Liquidated Damages

The parties may prescribe that if one party breaches the contract, it will pay a certain sum of liquidated damages to the other party in light of the degree of breach, or prescribe a method for calculation of damages for the loss resulting from a party's breach.

Where the amount of liquidated damages prescribed is below the loss resulting from the breach, a party may petition the People's Court or an arbitration institution to increase the amount; where the amount of liquidated damages prescribed exceeds the loss resulting from the breach, a party may petition the People's Court or an arbitration institution to decrease the amount as appropriate.

Where the parties prescribed liquidated damages for delayed performance, the breaching party shall, in addition to payment of the liquidated damages, render performance.

Article 115 Deposit

The parties may prescribe that a party will give a deposit to the other party as assurance for the obligee's right to performance in accordance with the Security Law of the People's Republic of China. Upon performance by the obligor, the deposit shall be set off against the price or refunded to the obligor. If the party giving the deposit failed to perform its obligations under the contract, it is not entitled to claim refund of the deposit; where the party receiving the deposit failed to perform its obligations under the contract, it shall return to the other party twice the amount of the deposit.

Article 116 Election Between Deposit or Liquidated Damages Clauses

If the parties prescribed payment of both liquidated damages and a deposit, in case of breach by a party, the other party may elect in alternative to apply the liquidated damages clause or the deposit clause.

Article 117 Force Majeure

A party who was unable to perform a contract due to force majeure is exempted from liability in part or in whole in light of the impact of the event of force majeure, except otherwise provided by law. Where an event of force majeure occurred after the party's delay in performance, it is not exempted from liability.

For purposes of this Law, force majeure means any objective circumstance which is unforeseeable, unavoidable and insurmountable.

Article 118 Duty to Notify in Case of Force Majeure

If a party is unable to perform a contract due to force majeure, it shall timely notify the other party so as to mitigate the loss that may be caused to the other party, and shall provide proof of force majeure within a reasonable time.

Article 119 Non-Breaching Party's Duty to Mitigate Loss in Case of Breach

Where a party breached the contract, the other party shall take the appropriate measures to prevent further loss; where the other party sustained further loss due to its failure to take the appropriate measures, it may not claim damages for such further loss.

Any reasonable expense incurred by the other party in preventing further loss shall be borne by the breaching party.

Article 120 Bilateral Breach

In case of bilateral breach, the parties shall assume their respective liabilities accordingly.

Article 121 Breach Due to Act of Third Person

Where a party's breach was attributable to a third person, it shall nevertheless be liable to the other party for breach. Any dispute between the party and such third person shall be resolved in accordance with the law or the agreement between the parties.

Article 122 Election of Remedy in Tort or in Contract

Where a party's breach harmed the personal or property interests of the other party, the aggrieved party is entitled to elect to hold the party liable for breach of contract in accordance herewith, or hold the party liable for tort in accordance with any other relevant law.

Sales Contract

Article 130 Definition of Sales Contract

A sales contract is a contract whereby the seller transfers title to the subject matter to the buyer, who pays the price.

Article 131 Additional Terms

In addition to the terms set forth in Article 12 hereof, a sales contract may include terms such as packing method, inspection standard and inspection method, method of settlement of account, and the language versions of the contract and the authenticity thereof, etc.

Article 132 Title or Disposal Power; Prohibition of or Restriction on Transfer

The seller shall have title to, or the power to dispose of, the subject matter for sale.

Where a law or administrative regulation prohibits or restricts the transfer of the subject matter, such provision applies.

Article 133 Passing of Title

Title to the subject matter passes at the time of its delivery, except otherwise provided by law or agreed by the parties.

Article 134 Conditional Sale

The parties may prescribe in the sales contract that title to the subject matter remain in the seller until the buyer has paid the price or has performed other obligations.

Article 135 Seller's Obligations with Respect to Title Transfer

The seller shall perform the obligations of delivering to the buyer the subject matter or the document for taking delivery thereof, as well as transferring title to the subject matter.

Article 136 Delivery of Related Materials by Seller

In addition to the document for taking delivery, the seller shall deliver to the buyer documents and materials related to the subject matter in accordance with the contract or in accordance with the relevant usage.

Article 137 Sales Involving Intellectual Property

In a sale of any subject matter which contains intellectual property such as computer software, etc., the intellectual property in the subject matter does not vest in the buyer, except otherwise provided by law or agreed by the parties.

Article 138 Time of Delivery

The seller shall deliver the subject matter at the prescribed time. Where the contract prescribes a period during which delivery is to take place, the seller may deliver at any time during the delivery period.

Article 139 Absence of Provision for Time of Delivery

Where the time for delivery of the subject matter was not prescribed or clearly prescribed, Article 61 and Item 4 of Article 62 apply.

Article 140 Time of Delivery of Subject Matter Already in Buyer's Possession

Where the subject matter was in buyer's possession prior to conclusion of the contract, the time when the contract becomes effective is the time of delivery

Article 141 Absence of Provision for Place of Delivery

The seller shall deliver the subject matter at the prescribed place.

Where the place of delivery was not prescribed or clearly prescribed, and cannot be determined in accordance with

Article 61 hereof, the following provisions apply:

(i) If the subject matter needs carriage, the seller shall deliver the subject matter to the first carrier for transmission to

the buyer;

(ii) Where the subject matter does not need carriage, if at the time of conclusion of the contract, the buyer and the seller knew the subject matter was at a particular place, the seller shall deliver the subject matter at such place; and if they did not know the location of the subject matter, delivery shall take place at the seller's place of business at the time of conclusion of the contract.

Article 142 Passing of Risk

The risk of damage to or loss of the subject matter is borne by the seller prior to delivery, and by the buyer after delivery, except otherwise provided by law or agreed by the parties.

Article 143 Risk Allocation in Case of Delayed Delivery

Where the subject matter was not delivered at the prescribed time due to any reason attributable to the buyer, the buyer shall bear the risk of damage to or loss of the subject matter as from the date of breach.

Article 144 Risk Allocation for Subject Matter in Transit

Where the seller sells the subject matter which has been delivered to a carrier for transportation and is in transit, unless otherwise agreed by the parties, the risk of damage or loss is borne by the buyer as from the time of formation of the contract.

Article 145 Passing of Risk in Case of Seller Arranged Carriage

Where the place of delivery was not prescribed or clearly prescribed, if the subject matter needs carriage as provided in Item (i) of Paragraph 2 of Article 141, the risk of damage to or loss of the subject matter is borne by the buyer as from the time the seller delivers the subject matter to the first carrier.

Article 146 Risk Allocation in Case of Delay in Taking Delivery

Where the seller placed the subject matter at the place of delivery in accordance with the contract or in accordance with Item (ii) of Paragraph 2 of Article 141 hereof and the buyer fails to take delivery in breach of the contract, the risk of damage to or loss of the subject matter is borne by the buyer as from the date of breach.

Article 147 Passing of Risk Notwithstanding Failure to Deliver Documents

Failure by the seller to deliver the documents and materials relating to the subject matter in accordance with the contract does not affect passing of the risk of damage to or loss of the subject matter.

Article 148 Rejection on Grounds of Quality Non-compliance; Risk Allocation in Case of Rejection

Where the purpose of the contract is frustrated due to failure of the subject matter to meet the quality requirements, the buyer may reject the subject matter or terminate the contract. If the buyer rejects the subject matter or terminates the contract, the risk of damage to or loss of the subject matter is borne by the seller.

Article 149 Right to Remedy Notwithstanding Assumption of Risk

Buyer's assumption of the risk of damage to or loss of the subject matter does not prejudice its right to hold the seller liable for breach of contract if the seller rendered non-conforming performance.

Article 150 Third Party Claim Warranty

The seller is obligated to warrant that the buyer will be free from any third party claim against it in respect of the subject matter delivered, except otherwise provided by law.

Article 151 Buyer's Knowledge Releasing Third Party Claim Warranty

Where the buyer knew or should have known that the subject matter was subject to a third party claim at the time of

conclusion of the contract, the seller does not assume the obligation prescribed in Article 150 hereof.

Article 152 Right to Withhold Payment in Case of Third Party Claim

Where the buyer has conclusive evidence establishing that a third person may make a claim on the subject matter, it may withhold payment of the corresponding price, except where the seller has provided appropriate assurance.

Article 153 Quality Specifications

The seller shall deliver the subject matter in compliance with the prescribed quality requirements. Where the seller gave quality specifications for the subject matter, the subject matter delivered shall comply with the quality requirements set forth therein.

Article 154 Absence of Prescribed Quality Requirements

Where the quality requirements for the subject matter were not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, Item (i) of Article 62 hereof applies.

Article 155 Quality Non-compliance Giving Rise to Claims

If the subject matter delivered by the seller fails to comply with the quality requirements, the buyer may hold the seller liable for breach of contract in accordance with Article 111 hereof.

Article 156 Packing Method

The seller shall deliver the subject matter packed in the prescribed manner. Where a packing method was not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, the subject matter shall be packed in a customary manner, or, if there is no customary manner, in a manner adequate to protect the subject matter.

Article 157 Inspection upon Receipt of Subject Matter

Upon receipt of the subject matter, the buyer shall inspect it within the prescribed inspection period. Where no inspection period was prescribed, the buyer shall timely inspect the subject matter.

Article 158 Consequence of Failure to Inspect; Exceptions

Where an inspection period was prescribed, the buyer shall notify the seller of any non-compliance in quantity or quality of the subject matter within such inspection period. Where the buyer delayed in notifying the seller, the quantity or quality of the subject matter is deemed to comply with the contract.

Where no inspection period was prescribed, the buyer shall notify the seller within a reasonable period, commencing on the date when the buyer discovered or should have discovered the quantity or quality non-compliance. If the buyer fails to notify within a reasonable period or fails to notify within 2 years, commencing on the date when it received the subject matter, the quantity or quality of the subject matter is deemed to comply with the contract, except that if there is a warranty period in respect of the subject matter, the warranty period applies and supersedes such two year period.

Where the seller knew or should have known the non-compliance of the subject matter, the buyer is not subject to the time limits for notification prescribed in the previous two paragraphs.

Article 159 Absence of Price Provision

The buyer shall pay the price in the prescribed amount. Where the price was not prescribed or clearly prescribed, the provisions of Article 61 and Item (ii) of Article 62 apply.

Article 160 Place of Payment

The buyer shall pay the price at the prescribed place. Where the place of payment was not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, the buyer shall make payment at the seller's

place of business, provided that if the parties agreed that payment shall be conditional upon delivery of the subject matter or the document for taking delivery thereof, payment shall be made at the place where the subject matter, or the document for taking delivery thereof, is delivered.

Article 161 Time of Payment

The buyer shall pay the price at the prescribed time. Where the time for payment was not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, the buyer shall make payment at the same time it receives the subject matter or the document for taking delivery thereof.

Article 162 Buyer's Option in Case Delivered Quantity Exceeds Prescribed Amount

Where the seller delivered the subject matter in a quantity greater than that prescribed in the contract, the buyer may accept or reject the excess quantity. Where the buyer accepts the excess quantity, it shall pay the price based on the contract rate; where the buyer rejects the excess quantity, it shall timely notify the seller.

Article 163 Title to Fruits Before and After Delivery

The fruits of the subject matter belong to the seller if accrued before delivery, and to the buyer if accrued after delivery.

Article 164 Effect of Termination on Grounds of Non-compliance of Main or Ancillary Components

Where a contract is terminated due to non-compliance of any main component of the subject matter, the effect of termination extends to the ancillary components. Where the contract is terminated due to non-compliance of any ancillary component of the subject matter, the effect of termination does not extend to the main components.

Article 165 Termination in Part or in Whole

Where the subject matter comprises of a number of components, one of which does not comply with the contract, the buyer may terminate the portion of the contract in respect of such component, provided that if severance of such component with the other components will significantly diminish the value of the subject matter, the party may terminate the contract in respect of such number of components.

Article 166 Effect of Termination in Case of Delivery in Installments

Where the seller is to deliver the subject matter in installments, if the seller's failure to deliver or non-conforming delivery of one installment frustrates the purpose of the contract in respect of such installment, the buyer may terminate the portion of the contract in respect thereof.

If the seller's failure to deliver or non-conforming delivery of one installment frustrates the purpose of the contract in respect of all subsequent installments notwithstanding their delivery, the buyer may terminate the portion of the contract in respect of such installment as well as any subsequent installment.

If the buyer is to terminate the portion of the contract in respect of a particular installment which is interdependent with all other installments, it may terminate the contract in respect of all delivered and undelivered installments.

Article 167 Termination in Case of Sale by Installment Payment

In a sale by installment payment, where the buyer failed to make payments as they became due, if the delinquent amount has reached one fifth of the total price, the seller may require payment of the full price from the buyer or terminate the contract. If the seller terminates the contract, it may require the buyer to pay a fee for its use of the subject matter.

Article 168 Quality Provisions in Case of Sale by Sample

In a sale by sample, the parties shall place the sample under seal, and may specify the quality of the sample. The subject matter delivered by the seller shall comply with the sample as well as the quality specifications.

Article 169 Latent Defect in Sample

In a sale by sample, if the buyer was not aware of a latent defect in the sample, the subject matter delivered by the seller shall nevertheless comply with the normal quality standard for a like item, even though the subject matter delivered complies with the sample.

Article 170 Sale by Trial

In a sale by trial, the parties may prescribe the trial period. Where a trial period was not prescribed or clearly prescribed, and cannot be determined in accordance with Article 61 hereof, it shall be determined by the seller.

Article 171 Purchase or Rejection During Trial Period

In a sale by trial, the buyer may either purchase or reject the subject matter during the trial period. At the end of the trial period, the buyer is deemed to have made the purchase if it fails to manifest its intention to purchase or reject the subject matter.

Article 172 Sale by Tender Governed by Relevant Laws

In a sale by tender, matters such as the rights and obligations of the parties and the tendering procedure, etc. are governed by the relevant laws and administrative regulations.

Article 173 Sale by Auction Governed by Relevant Laws

In a sale by auction, matters such as the rights and obligations of the parties and the auctioning procedure, etc. are governed by the relevant laws and administrative regulations.

Article 174 General Applicability to Contracts for Value

For any other contract for value, if the law provides for such contract, such provisions apply; absent any such provision, reference shall be made to the relevant provisions governing sales contracts.

Article 175 Applicability to Barter Transaction

Where the parties agree on a barter transaction involving transfer of title to the subject matters, such transaction shall be governed by reference to the relevant provisions governing sales contracts.

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