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A Relational Approach to Property Rights Change: Comparing English Enclosures and Chinese Rural Land Reform

Max JOITE[*]

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[*] Max JOITE is a trainee lawyer (Referendar) at the Higher Regional Court of Berlin. LL.M. 2016, University of Hong Kong; LL.B. 2014, Bucerius Law School. The dissertation forming the basis of this article was awarded the University of Hong Kong Winston Chu & Co. Prize in Law 2015–16. The author would like to thank Dr. Shitong Qiao, who inspired and encouraged his study of comparative property law.

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I. INTRODUCTION

The law and economics approach dominates explanations of past and proposals for future property rights reforms. In recent years, scholars have increasingly considered it incomplete.[1] Some have proposed a social relations perspective,[2] a proposal I pursue further. No one seems yet to have used a historical comparative approach. How does this approach contribute to the debate?[3] A comparison shows how two reforms, which from the economic perspective appear very similar, diverge in their impact on society. It illustrates how a social relations perspective detects patterns that explain the reforms' diverging impact.

Two questions can be asked with regard to property rights reform: *What* has changed? And *how* was it changed? The first inquiries into the *change*, the second into the *process* of reform. Past works on the relation of law and social relations offer a framework to study both the *change* Chinese and English reforms entailed and the *process* they followed. With regard to property rights *change*, I observe that the English reform challenged exist-

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[1] For a recent suggestion from inside the field of law and economics to pursue comparative studies beyond the focus on efficiency, see Giovanni B. Ramello, *The Past, Present and Future of Comparative Law and Economics*, *in* COMPARATIVE LAW AND ECONOMICS 3, 14 (Theodore Eisenberg & Giovanni B. Ramello eds., 2016). For an account on the limitations of the economic perspective on property rights change, see, e.g., Katrina M. Wyman, *Problematic Private Property: The Case of New York Taxicab Medallions*, 30 YALE J. ON REG. 125, 147–55 (2013).

[2] Daniel Fitzpatrick and Hernando de Soto both have studied conflicts that arise where property rights change is disputed by existing social relations. Daniel Fitzpatrick, *Evolution and Chaos in Property Rights Systems: The Third World Tragedy of Contested Access*, 115 YALE L.J. 996, 1046–47 (2006); HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE 181–85 (2000). This is a social relations perspective on the *change* brought about by property rights reform. Shitong Qiao and Frank Upham offer a concept of "relational property," which serves to describe the *process* of property rights evolution induced by social relations. Shitong Qiao & Frank Upham, *The Evolution of Relational Property Rights: A Case of Chinese Rural Land Reform*, 100 IOWA L. REV. 2479, 2488–91 (2015). De Soto also briefly explores this approach. DE SOTO, *supra*, at 190. This is a social relations perspective on the *process* of property rights reforms. On the legal scholarship's interest in social relations and social norms, see generally Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 542 (1998).

[3] On the benefits of a comparative approach in general, and of its use in law and economics in particular, see Ramello, *supra* note 2, at 13–16.

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ing social relations, and prevailed over them. The Chinese reform widely harmonized with existing social relations, and where it challenged them, the relations tended to prevail. With regard to reform *process*, I find that both Chinese and English reforms were at first induced by social relations. At a certain point however, the English reform process transformed, and reforms were henceforth imposed by legislation. Together, the differences in change and process account for the occurrence of social conflict in England and its absence in China.

My article proceeds as follows. Part II introduces the Chinese and English land reforms, observing how both entail an individualization and consolidation of property rights. Part III adopts a classical economic perspective to describe the Chinese and English reforms, to highlight how important parts of these reforms cannot be understood from this angle. Part IV introduces the social relations perspective on property rights. Part V describes the change, part VI the process of Chinese and English reforms from this perspective. Together they reveal social relations patterns that illustrate those parts of the Chinese and English reforms that the economic perspective left unseen. Part VII concludes.

II. CHINESE AND ENGLISH PROPERTY RIGHTS REFORM

The following part introduces the objects of my comparative analysis. It gives an overview of the property rights changes in the Chinese rural land reform and English enclosures. Before studying these reforms, I develop a concept of property rights suitable to describing them.

A. What Are Property Rights?

Property rights can be perceived as a person's relation to land (*in rem*), a relation often depicted as unitary (ownership),[4] and at times even as absolute (Blackstonian).[5] A social relations

[4] For a study of property rights evolution based on this conception, see Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1336–38, 1341–42 (1993).

[5] Based on SIR WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND IN FOUR BOOKS, BOOK 2 2 (1765) ("(T)hat sole and despotic dominion"). For a theoretical exploration of this perception, see Abraham Bell & Gideon Parachomovsky, *A Theory of Property*, 30 CORNELL L. REV. 531, 543–44 (2005).

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perspective suggests a perception that is both broader and more gradual: Property rights are legal relations between persons (*in personam*) with regard to the land.[6] Such property relations are complex and varied. A notion of ownership often does not fully capture them. A historical comparative perspective studies a great variety of regimes, aggravating this problem.[7] I will therefore turn to the bundle-of-sticks metaphor of Legal Realism: Property is a bundle of individual sticks (the property rights), which come in a variety of shapes and sizes.[8] They can be consolidated in one hand or scattered into many. To this distinction of consolidated/scattered property rights, I add one of individual/common: Individual property rights are singular (i.e. no other person holds this right to this plot of land), common property rights are not. The broadest form of common property is open access.[9]

For a recent example of a scholar using this depiction of property, see PROPERTY RIGHTS DYNAMICS: A LAW AND ECONOMICS PERSPECTIVE 1 (Donatella Porrini & Giovanni B. Ramello eds., 2007) ("Property rights grant the holder exclusive rights over a given resource."). For a critical account on how Blackstone came to be associated with that particular account of property, see David B. Schorr, *How Blackstone Became a Blackstonian*, 10 THEORETICAL INQUIRIES IN LAW 103, 104–06, 123–24 (2009).

[6] *See, e.g.*, Joseph W. Singer, *Property and Social Relations: From Title to Entitlement*, *in* PROPERTY AND VALUES: ALTERNATIVES TO PUBLIC AND PRIVATE OWNERSHIP 3, 8 (Charles Geisler & Gail Daneker eds., 2nd ed. 2000); Qiao & Upham, *supra* note 3, at 2481–82; on the distinction between property rights and other legal rights, see GARY D. LIBECAP, CONTRACTING FOR PROPERTY RIGHTS 1 (1994).

[7] The notion of ownership as absolute property can indeed be regarded as a rather modern invention. *See generally* Francesco Parisi, *The Fall and Rise of Functional Property*, *in* PROPERTY RIGHTS DYNAMICS: A LAW AND ECONOMICS PERSPECTIVE 1, 24–25 (Donatella Porrini & Giovanni B. Ramello eds., 2007).

[8] There are various classifications for the individual sticks in the bundle. Commonly they are separated into the right to use the asset (use rights), to reap the benefits from the use (residual rights) and to transfer it to another party (transfer rights). *See generally* Timothy Besley & Maitreesh Ghatak, *Property Rights and Economic Development*, *in* HANDBOOK OF DEVELOPMENT ECONOMICS, VOL. 5 4525, 4526 (Dani Rodrik & Mark Rosenzweig eds., 2010). For an account of the origin of the bundle of sticks metaphor, see Henry E. Smith, *Property Is Not Just a Bundle of Rights*, 8 ECON J. WATCH 279, 279-81 (2011). For a critical account of its use, see *id.* at 284–87.

[9] *See* Hanoch Dagan & Michael A. Heller, *The Liberal Commons*, 110 YALE L.J. 549, 556–57 (2001).

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B. Chinese Rural Land Reform

Before as after the rural land reform (1978-1983[10]), near all Chinese rural land was, and is, collectively owned *de jure*.[11] According to property rights theory, collective ownership describes the consolidation of all sticks of the property rights bundle in the hands of one group, each member of which shares in them equally.[12] Throughout PRC history however, this stipulation covered quite different arrangements of property rights, as property rights responded to a shifting political, economic and social environment.[13] The reform examined here, the transformation from the production team to the Household Responsibility System (HRS, officially Household Contract Responsibility System, *jiating chengbao zerenzhi*), is only the most recent comprehensive rural land reform.

1. Production Team System

Pre-reform, we may distinguish two property relations. The first relation connected villagers who together formed a produc-

[10] The timeframe of 1978-1983 refers to the *introduction* of the HRS, and by the end of 1983 the near-entirety of Chinese collectives had adopted it. The Chinese rural land rights system has seen repeated reforms even after 1983, and these will also be covered in my description. Indeed, the reform process appears still to be ongoing. *See, e.g.*, Ren Wei, *Time to Unlock Rights to Rural Land: China's Finance Minister*, S. CHINA MORNING POST (Jan. 3, 2016), *available at* http://www.scmp.com/news/china/economy/article/1897830/time-unlock-rights-rural-land-chinas-finance-minister (citing Finance Minister Lou Jiwei's proposal to further commodify rural property rights, published in the Chinese Communist Party (CCP) journal *Qiushi*).

[11] Now according to Article 10 of the 1982 Constitution of the People's Republic of China. Collective ownership applies to the vast majority of rural land that is not owned by the state.

[12] *See, e.g.*, Harold Demsetz, *Toward a Theory of Property Rights*, 57 AMERICAN ECON. REV. 347, 354 (1967); Ellickson, *supra* note 5, at 1336–37.

[13] Following a movement of land-to-the-tiller redistribution in 1949, collective ownership was gradually introduced in the years after 1951, with the CCP organizing households into agricultural producers' cooperatives (comprising ca. 160 households each). *See* Robin Dean & Tobias Damm-Luhr, *A Current Review of Chinese Land-Use Law and Policy: A "Breakthrough" in Rural Reform?*, 19 PAC. RIM L. & POL'Y J. 121,124–25 (2010). In 1958 households were organized into people's communes (comprising ca. 5,000 households each). *See* Vivienne Shue, *The Fate of the Commune*, 10 MODERN CHINA 259, 259 (1984). After the failed Great Leap Forward, the agricultural production in 1962 was again decentralized from commune to production team. *See* PETER HO, INSTITUTIONS IN TRANSITION: LAND OWNERSHIP, PROPERTY RIGHTS AND SOCIAL CONFLICT IN CHINA 6 (2005).

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tion team. It was a relation of common property rights. Each villager had the right (and indeed, the duty) to work on the production team's land in collaboration with the others, and the right to a share in the residue. Both use and residue were governed by a rule that affected all villagers equally, theoretically rendering their property rights equal.[14] The share of the revenue was determined by a work point system, supposed to respond to each villager's efforts, but in practice often leading to egalitarian distribution.

The second property relation linked the production team (*shengchan dui*), the production brigade (*shengchan dadui*), and the commune (*renmin gongshe*) in what was called "three-level ownership with the production team as a basis."[15] The relation was marked by a fragmentation of the individual sticks in the property rights bundle, which were scattered between these actors. The production team had the right to use the land. However, decisions on general management and access to land lay with the people's brigade or commune.[16] The production team could neither transfer the land, nor defend it against requisition by the state.[17]

2. Household Responsibility System

The introduction of the HRS marks a consolidation of property rights (where before they had been scattered among production team, production brigade and commune), and their individualization (where before they had been commonly held). Again there are two kinds of property relations, now governing two

[14] In practice, powerful positions of village cadres may have altered this equitable distribution of rights. Village cadres held "a near monopoly over the management and allocation of economic resources" in the village. Victor Nee & Su Sijin, *Institutional Change and Economic Growth in China: The View from the Villages*, 49 J. ASIAN STUD. 3, 4 (1990). *See similarly* Geoffrey Korff, *The Village and the City: Law, Property, and Economics Development in Rural China.*, 35 SYRACUSE J. INT'L L. & COM. 399, 408 (2007–2008). Poor supervision allowed the cadres to benefit from that control in distributing higher work points and better jobs along family lines. Nee & Sijin, *supra*, at 20. For a definition of cadres, see Korff, *supra*, at 401.

[15] Frank Xianfeng Huang, *The Path to Clarity: Development of Property Rights in China*, 17 COLUM. J. ASIAN L. 191, 214 (2003–2004).

[16] *See* HO, *supra* note 14, at 12; Korff, *supra* note 15, at 407–08, 410; Louis Putterman, *The Role of Ownership and Property Rights in China's Economic Transition*, 144 CHINA QUARTERLY 1048, 1052 (1995).

[17] *See* HO, *supra* note 14, at 12.

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types of village land: The majority of village land is subject to individual property rights, while a minority remains common property.

The first property relation is one between individual household (a legal entity in rural China) and the village. It is now formalized in Chapter II of the Rural Land Contract Law (RLCL[18]). The village (assignor) owns the land, and assigns fixed-period land use rights to all village households (assignees) individually on the basis of a contract (*chengbao*).[19] The contracts differ from a lease agreement in that the use of the land is restricted to either agricultural use or housing land. Use rights to agricultural land can be transferred in the form of a sub-lease (Article 32 of the RLCL). The land use rights are thus individual property rights (to use, to residue and, albeit restricted, to transfer). Not fully consolidated parts of the property rights to land remain with the village collective (e.g., the right to re-assign land[20]).

A second property relation governs the commons remaining in some villages. They are not covered by the HRS, and were meant to remain subject to collective management. As such management declined following the institutional changes accompanying the HRS, these plots are left in a vacuum of governance often leading to open access.[21]

C. English Enclosures

The English enclosures marked the transformation from the common (alternatively called open) field system to enclosed land. To the English countryside as a whole it was a transformation that

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[18] 农村土地承包法 [Rural Land Contract Law], (promulgated by the Nat'l People's Cong., Aug. 29, 2002, effective Mar. 1, 2003) Chapter II.

[19] This is the most common collective-household relation in rural China. On other forms of collective ownership, see Albert H. Y. Chen, *The Law of Property and the Evolving System of Property Rights in China*, *in* THE DEVELOPMENT OF THE CHINESE LEGAL SYSTEM: CHANGE AND CHALLENGES 81, 100 (Guanghua Yu ed., 2011). The lease period has been repeatedly reformed since the introduction of the HRS, from five years to fifteen (1984) and then thirty years (1993), confirmed by the Revised Land Administration Law of 1998.

[20] Now prescribed (and greatly restricted compared to previous practice) in Article 27 of the RLCL.

[21] *See* Shitong Qiao, *Governing the Post-Socialist Transitional Commons: A Case from Rural China*, 24 COLO. J. INT'L ENVTL. L. & POL'Y, 121 (2013).

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spread over centuries, yet for the individual villages affected the change was sudden and complete.

1. Common Fields

The pre-enclosure system of common fields is difficult to describe because its rules were diverse[22] and their details remain disputed.[23] We may assume however that it was widespread (if not universal)[24] in England, and we may give an ideal-typical[25] account of its regime. We can distinguish two types of land in the village, each marked by a relation of common property rights (and named "common land"[26] at the time).

The first property relation ruled arable and meadow, the most important village lands. They were subject to a two-layered "marble cake"[27] of property rights, being individual in summer and common in winter. Arable land lay in two or three large fields.[28] Villagers held one or several narrow strips on them for

[22] The plurality of property rights regimes is owed to local arrangements, created and modified through by-laws (i.e. laws made by local authorities), by implicit contracts or through local custom. *See e.g.*, Gregory Clark & Anthony Clark, *Common Rights to Land in England, 1475–1839*, 61 J. ECON. HIST. 1009, 1009 (2001); Leigh Shaw-Taylor, *Parliamentary Enclosure and the Emergence of an English Agricultural Proletariat*, 61 J. ECON. HIST. 640, 641–44 (2001).

[23] *See generally* Frank A. Sharman, *An Introduction to the Enclosure Acts*, 10 J. LEGAL HIST. 45, 45 (1989) ("(A)lmost every question . . . about enclosures seems to have no certain answer.").

[24] It seems long to have been scholarly consensus the majority of land had common rights attached to it. JOHN LAWRENCE HAMMOND & BARBARA BRADBY HAMMOND, THE VILLAGE LABOURER, 1760–1832 (A Study in the Government of England Before the Reform Bill) 1 (1920) (citing sources according to which in 1685 three-fifths of English agricultural land was subject to the common fields system). For a recent (and more cautious) estimation, see Clark & Clark, *supra* note 23, at 1009.

[25] The use of the term ideal type here and below will follow Max Weber's definition. MAX WEBER, WIRTSCHAFT UND GESELLSCHAFT 9–11 (1922) (describing ideal types, a tool for analyzing the multitude of historical facts from a sociological perspective, as human interaction that follows a common pattern only differing in degrees of quantity).

[26] The arable fields, common meadowland and the waste were all named "common" at the time. *See* HAMMOND & HAMMOND, *supra* note 25, at 4.

[27] Ellickson, *supra* note 5, at 1388.

[28] These fields were usually used for crop rotation, thus one of them usually lay fallow. *See e.g.*, Shaw-Taylor, *supra* note 23, at 642; Robert C. Allen, *Community and Market in England: Open Fields and Enclosures Revisited*, *in* COMMUNITES AND MARKETS IN ECONOMIC DEVELOPMENT 42, 42 (Masahiko Aoki & Yujiro Hayami eds., 2001).

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cultivation.[29] They were unfenced, and if villagers held several strips, these were usually scattered.[30] Each villager cultivated his own strip, yet in doing so was subject to common rights: The strips were to be cultivated uniformly. Those holding strips in the fields collectively determined crop rotation, fallow years, and the time for spring planting and harvest.[31] The village meadow was governed by a regime similar to that of arable land.[32]

Between harvest and spring planting, as well as during fallow years, fields were subject to common property rights entirely.[33] Their use was reserved to holders of common rights. Common rights were individual sticks from the bundle of property rights governing the common land, entitling their holder to use this land in a certain way. These usually were pasture rights, and their extent (i.e. the number of animals allowed) was specified (stinted).[34] Not all villagers held common rights. Landed peasants (i.e. those holding a strip on the field) always had common rights.[35] Villagers dwelling in certain village houses (the common-right cottages) also had common rights, usually restricted to

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[29] The amount of strips held by villagers differed widely, from the many strips held by village lords and large landowners to individual strips that alone could not afford a living. *See generally* HARRIET BRADLEY, THE ENCLOSURES IN ENGLAND: AN ECONOMIC RECONSTRUCTION 46 (1918). Villagers held their strips under a variety of legal titles, the intricacies of which will not concern us here. On the varying titles, see Sharman, *supra* note 25, at 67 (on copyhold and tithes); J. R. Wordie, *The Chronology of English Enclosure, 1500–1914*, 36 ECON. HIST. REV. 483, 504 (1983) (on rent).

[30] *See* Allen, *supra* note 29, at 42; S. J. Thompson, *Parliamentary Enclosure, Property, Population, and the Decline of Classical Republicanism in Eighteenth-Century Britain*, 51 HIST. J. 621, 623 (2008).

[31] For a detailed account on the decision-making process, see HAMMOND & HAMMOND, *supra* note 25, at 6–7; Allen, *supra* note 29, at 42-43, 59. *See further* Ellickson, *supra* note 5, at 1388.

[32] Here too individual plots were assigned, and after haymaking the entire land was used for common pasture. *See* HAMMOND & HAMMOND, *supra* note 25, at 4.

[33] *See e.g.*, Allen, *supra* note 29, at 42; Shaw-Taylor, *supra* note 23, at 642. In some villages, there were (usually fenced) stinted pastures, subject to common rights year-round. *See* Clark & Clark, *supra* note 23, at 1009.

[34] *See* Thompson, *supra* note 31, at 623; Allen, *supra* note 29, at 42. Other common rights were to cut turf on and to get fuel from the commons. *See* HAMMOND & HAMMOND, *supra* note 25, at 7. The right to squatting may also at times have been a common right. *See* Shaw-Taylor, *supra* note 23, at 644.

[35] *See* HAMMOND & HAMMOND, *supra* note 25, at 7; Shaw-Taylor, *supra* note 23, at 642–43.

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the grazing of two cows and a few sheep.[36] Some common rights were tradable,[37] and others could be hired.[38]

The waste (also called the common[39]) was unstinted common land, subject to open access.[40] It was found in most villages, its texture and proportion varying widely. There is some agreement that wastes were generally small, and their land of little agricultural value.[41] They were widely used as year-round pasture.[42] Other uses varied with the wastes' texture, but typically included fuel gathering,[43] hunting,[44] and squatting.[45]

2. Enclosed Land

Enclosure[46] marked the end to the common arable, meadow and waste. Individual and common rights were abolished. Enclosure could and often did ignore the old boundaries of fields, barriers, roads or even buildings. "(T)he slate (was) wiped clean."[47] In a second step, new plots were designated, and new property rights assigned. These were awarded to villagers in accordance to their previous rights' value.[48] This change was an individualization and consolidation of property rights. It individualized property rights since the new rights were always singular.

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[36] *See* Shaw-Taylor, *supra* note 23, at 642–43, 650.

[37] *See* Clark & Clark, *supra* note 23, at 1030–32.

[38] *See* Jane Humphries, *Enclosures, Common Rights, and Women: The Proletarianization of Families in the Late Eighteenth and Early Nineteenth Centuries*, 50 J. ECON. HIST. 17, 23 (1990).

[39] *See* HAMMOND & HAMMOND, *supra* note 25, at 4; ROGER J. P. KAIN et al., THE ENCLOSURE MAPS OF ENGLAND AND WALES 1595–1918 5 (2004).

[40] *See* Clark & Clark, *supra* note 23, at 1032; *but see* HAMMOND & HAMMOND, *supra* note 25, at 8, contending the access to the wastes was limited *de jure*, if not *de facto*.

[41] For a skeptical view on the value of wastes, see Clark & Clark, *supra* note 23, at 1032, 1035; for a more positive account, see Humphries, *supra* note 39, at 18–19.

[42] *See* HAMMOND & HAMMOND, *supra* note 25, at 4; KAIN et al., *supra* note 40, at 5.

[43] *See* Humphries, *supra* note 39, at 32; Sharman, *supra* note 24, at 59.

[44] *See* Humphries, *supra* note 39, at 32.

[45] *See* HAMMOND & HAMMOND, *supra* note 25, at 7.

[46] Enclosure may refer to both the physical fencing of a land, and the process of removal of common rights described here. In this essay, I will use the term in the latter meaning. On different uses, see generally KAIN et al., *supra* note 40, at 1.

[47] Sharman, *supra* note 24, at 46.

[48] *See id.* at 46, 60.

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It consolidated the sticks in the property rights bundle in the hand of the owner or tenant, who controlled his plot unhindered by common rights. It also consolidated the plots themselves: From a villager's scattered strips to one plot of regular shape.

D. Comparative View

From a legal perspective, Chinese and English reforms appear to be rather similar. Both depart from a system marked by common property rights (among production team members in China, among common rights holders in England) to one of individual property (of the household, of the villager). Both also seek to consolidate the previously scattered sticks of the property rights bundle in one, or few hands: In China they are now shared only among members of a household (and, to a much lesser degree among the village), in England they are consolidated in the hand of the owner of enclosed land.

III. LAW AND ECONOMICS PERSPECTIVE

How does the law and economics perspective explain the Chinese and English reforms? Property rights are economic, i.e. they create a pattern of costs and benefits for society. On this observation Harold Demsetz based his influential economic narrative of property rights change: Property rights arise when their benefits for society exceed their costs, and they change accordingly, each change rendering resource allocation more efficient than before.[49]

Property rights serve to internalize externalities:[50] They consolidate the benefits and the costs of using a resource in the

[49] *See* Demsetz, *supra* note 13, at 350. Efficiency is here defined as a result of a cost-benefit calculus (i.e. gains minus the costs), following Saul Levmore, *Two Stories about the Evolution of Property Rights*, 31 J. LEGAL STUD. 421, 425 (2002). On efficiency of rights allocation, see generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 44 (1960).

[50] For a definition of externalities, see Demsetz, *supra* note 13, at 348 ("(T)he concept includes external costs, external benefits, and pecuniary as well as nonpecuniary externalities."). For Demsetz, the internalization of externalities is the primary purpose of property rights. Its importance is such that he reformulates his initial thesis accordingly: "(P)roperty rights develop to internalize externalities when the gains of internalization become larger than the cost of internalization." *Id.* at 350.

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person who holds property rights to it.[51] How does internalizing externalities increase efficiency? First, when externalities that are internalized one no longer needs to negotiate with those affected by it, which reduces transaction costs.[52] Second, where an externality cannot be internalized, property rights can identify the person affected, reducing the cost of negotiation.[53] Third, and perhaps most importantly, internalizing externalities guides incentives towards a more efficient resource use.[54] Apart from internalizing externalities, property rights facilitate to monitor the rules to using a resource.[55] According to Demsetz, change is triggered exogenously, by changes in market values, in production, and in technology.[56] Where society recognizes these new developments, it seeks to adjust property rights to "new benefit-cost possibilities"[57] they bring. In this way, property regimes unsuited to capture the newly arisen benefits are undermined.[58]

How does the Demsetzian perspective explain the reforms in China and England? Demsetz focuses on a unidirectional change from open access towards individual property rights,[59] and this encompasses the Chinese and English reforms. Their individualization and consolidation of property rights entailed an internalization of externalities. This increased incentives and decreased transaction costs, leading to a greater efficiency of land use in both China and England.

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[51] *See id.* at 355.

[52] *See* Wyman, *supra* note 2, at 142.

[53] *See* Demsetz, *supra* note 13, at 356.

[54] *See id.* at 348.

[55] *See id.* at 356. For an elaboration of Demsetz' approach, see Wyman, *supra* note 2, at 143. Property rights also have been found to reduce the costs of governance in facilitating to identify those transgressing the rules. *See* DE SOTO, *supra* note 3, at 53–54.

[56] *See* Demsetz, *supra* note 13, at 350 ("new ways of doing the same things, and doing new things.").

[57] *Id.*

[58] *See generally* LIBECAP, *supra* note 7, at 2.

[59] Demsetz' approach in the first part of his essay is to examine how ownership (be it private, communal or state ownership, the three idealized forms of ownership he identifies) arises from open access. Only then does he discuss benefits of specific ownership forms, in asserting the supreme effectiveness of private ownership.

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A. China, Economically

The production team system created multiple externalities. Each villager's effort in the team affected the residue that would eventually be spread among all villagers. Each villager's use of fertilizer reduced the common stock. As predicted by Demsetz, these externalities created incentive problems. Because they collectivized the results of each villager's effort, the production team relied on collective action (i.e. individual efforts for shared benefit). The resulting problems can be explained along the lines of Mancur Olson's theory of collective action:[60] As effort-dependent remuneration (the work point system) proved impractical, residue was shared egalitarian. While maximum effort of all parties would create optimal benefits for all, individual effort did not pay off.[61] In the absence of effective sanctioning, undercontribution was widespread[62] and so was the waste of resources.[63] According to Olson's theory, social relations may generate remu-

[60] According to Olson, in competitive markets all companies might benefit from a general decrease in production, because according to the rules of supply and demand, the price for a single unit of production would then increase. However, if to attain that goal one company reduces its production, all others share the benefit of its sacrifice. Hence, its own benefit is no more than the total benefit divided by the number of participants in the market. Therefore, it pays for no company to sacrifice for the general good. In the end, all companies run to their limits of capability, the prices fall accordingly, and every member is worse off than if they had adjusted their production to maximize collective gains. *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 10–11 (1971).

[61] Peasants' additional efforts were translated into a greater pie, the share of which however stayed the same. Their increased work only translated in increased revenue divided by the number of other members of the production team. *See generally* Justin Yifu Lin et al., *Lessons of China's Transition to a Market Economy*, 16 CATO J. 201, 212 (1996–1997).

The weakness of collective incentives was worsened by two factors external to the production team: Firstly, the failure of the Great Leap Forward led peasants to strategies focusing on the strengthening of their individual household, their private plot and husbandry. Secondly, the state procurement of parts of the harvest may have reduced incentives. *See generally* Nee & Sijin, *supra* note 15, at 7–8.

[62] *See* Justin Yifu Lin, *The Household Responsibility System Reform in China: A Peasant's Institutional Choice*, 69 AM. J. AGRIC. ECON. 410, 412 (1987).

[63] *See* Nee & Sijin, *supra* note 15, at 7 (reporting how village cadres recall wasting fertilizer because they "always thought (they) could get more fertilizer when what (they) had was used up.").

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nerations (e.g. social status) that replace economic incentives.[64] Although production teams were small enough for such social incentives to be effective, they proved unable to stabilize effort.[65] The problem was aggravated by managerial agency problems: Management decisions on levels above the production team (i.e. in the production brigade and the commune) created externalities for all their inhabitants, while affecting the decision-makers themselves less than all others.[66] Only the introduction of the HRS internalized the externalities of villagers' efforts, and removed them from cadre management decisions. As predicted by Olson,[67] this increased work incentives and rendered land management more flexible.[68] In both ways the HRS caused an increase in land use efficiency.[69]

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[64] Since "social status and social acceptance are individual, non-collective goods," social relations can affect a re-individualization of incentives where collective action has failed. *See* OLSON, *supra* note 61, at 61.

[65] Social incentives function particularly well in small groups. *See id.* The production team in theory is small enough to satisfy Olson's criteria. *See* Nee & Sijin, *supra* note 15, at 8. Yet cadre activism ("personal example, exhortations, and ideological sanctions") did not succeed in raising productivity except in mass-mobilization campaigns, which inevitably were of short-lived nature. *See* Nee & Sijin, *supra* note 15, at 8–9. Scholars believe that social incentives were undermined in particular by the opportunities to corruption the system offered. *See id.* at 6.

[66] While its members chose the head of the production team, commune and production brigades were political institutions marked by authoritarian leadership of party cadres. *See* Alexander F. Day, *A Century of Rural Self-Governance Reforms: Reimagining Rural Chinese Society in the Post-Taxation Era*, *in* RURAL POLITICS IN CONTEMPORARY CHINA 14, 24 (Emily T. Yeh et al. eds., 2015). Cadres were assigned by higher administrative levels and were not dependent on their collectives' output for revenue, but were on state payroll. *See generally* Shue, *supra* note 14, at 263; Korff, *supra* note 15, at 410; Nee & Sijin, *supra* note 15, at 8.

[67] *See* OLSON, *supra* note 61, at 7 ("Individual interests can be advanced, and usually advanced most efficiently, by individual, unorganized action.").

[68] *See* Putterman, *supra* note 17, at 1052–53; Alan Gelb et al., *Can Communist Economies Transform Incrementally? The Experience of China*, 8 NBER MACROECONOMICS ANNUAL 87, 125 (1993).

[69] The years after 1978 saw a rapid and sustained increase in income for Chinese peasants, the first since the 1950s. *See* Lee Travers, *Post-1978 Rural Economic Policy and Peasant Income in China*, 24 CHINA QUARTERLY 241, 252 (1984). Peasants' mean per capita income rose by 190 per cent (inflation adjusted) from 1978 to 1987, with growth slowing done in the following years. *See* Nee & Sijin, *supra* note 15, at 5 (1990). Scholars consent that the HRS is the single most important cause of these developments, with the general marketization of economy or the introduction of modern production tools being secondary. *See generally* Lei Feng et al., *Land Reallocation Reform in Rural China: A Behavioral Economics Perspective,* SSRN (Feb. 4, 2014), *available at*

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B. England, Economically

A dominant narrative[70] of English rural history explains enclosures in Demsetzian economic terms. This view was broadly shared by contemporaries of enclosure,[71] yet was increasingly subject to doubt in recent decades.[72] The open fields had scattered property rights to the same plots among the villagers. Villagers were thus subjected to externalities of others' use: Villagers grazing their cattle on the same meadow affected each other, and those using open fields for cropland in summer affected those using them for pasture in winter. The villagers had sought to reign in these externalities by a complex system of land use.[73] Such a regime necessitated negotiation, prior agreement on many practical questions, and monitoring.[74] The decision-making process (often requiring unanimity or near-unanimity) was so inflexible that it could not effectively respond to new techniques and market opportunities.[75] In Demsetzian terms, the cost thus created was

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http://ssrn.com/abstract=2389980; Alison Clarke, *Integrating Private and Collective Land Rights: Lessons from China?*, 7 J. COMP. L., 183–84 (2012). *See further* Yaohui Zhao & G. James Wen, *Chinese Rural Security and Land Holding*, *in* SOCIAL SECURITY REFORM: OPTIONS FOR CHINA 278, 283–84 (Jason Z. Yin et al., 2000) (observing that labor production rose by at least 40 per cent).

[70] On the different approaches to explaining enclosure, see generally KAIN ET AL., *supra* note 40, at 2–6.

[71] For reports on contemporary opinion, see *id.* at 4. *See further* HAMMOND & HAMMOND, *supra* note 25, at 16 ("(T)he enterprise of the age was under the spell of the most seductive economic teaching of the time.").

[72] *See* Gregory Clark, *Commons Sense: Common Property Rights, Efficiency, and Institutional Change*, 58 J. ECON. HIST. 73, 74, 76 (1998); Rosa Congost, *Property Rights and Historical Analysis: What Rights? What History?*, 51 PAST & PRESENT 73, 87 (2003); J. A. Yelling, *Rationality in the Common Fields*, 35 ECON. HIST. REV. 409, 414 (1982); Allen, *supra* note 29, at 43–46.

[73] E.g., in agreeing to stints that restricted the access to certain numbers of cattle for each villager, see Humphries, *supra* note 39, at 27–28; Clark & Clark, *supra* note 23, at 1030–32. Other agreements settled the time of harvest and spring planting.

[74] *See* Joan Thirsk, *Enclosing and Engrossing*, *in* THE AGRARIAN HISTORY OF ENGLAND AND WALES. VOLUME 4 1500–1640 200, 255 (Joan Thirsk ed., 1967) ("(P)eople had to . . . agree upon crop rotations, stints of common pasture, the upkeep and improvement of their grazings and meadows, the clearing of ditches, the fencing of fields.").

[75] *See* HAMMOND & HAMMOND, *supra* note 25, at 6–7 (observing how no earlier than 1773 was unanimity replaced by a majoritarian rule of three-quarters). These restrictions were said to prevent fodder crops. *See* KAIN et al., *supra* note 40, at 3. They also hindered the conversion of open fields to sheep pastures. *See* Thompson, *supra* note 31, at 623. *But see* JEANNE M. NEESON, COMMONERS: COMMON RIGHT, ENCLOSURE AND SOCIAL CHANGE IN ENGLAND, 1700–1820, 7

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caused by transactions over externalities.[76] Again other externalities directly impacted villagers' incentives: Investment in the narrow strips of land on the open fields was not fully remunerated, as in parts it would positively affect one's neighbors.[77] Investment in the wastes would benefit all villagers, and as a consequence was very rare.[78] Only when enclosure brought about the consolidation of property rights and land plots, these externalities were internalized. In an effect not addressed by Demsetz,[79] enclosures also increased efficiency through expanding economics in scale.[80] All seems to have made the post-enclosure property regime more efficient: "When communalism ended, progress began."[81]

Economically, reforms follow a cost/gain calculus. The greater efficiency of enclosed land is only the *gain* of reform. The *cost* is another variable of the Demsetzian theory.[82] It adds to explaining why enclosures did neither occur earlier nor later. The costs of enclosures were significant, and they were one-off costs, borne by a single generation in the village.[83] As these costs re-

(1996); Allen, *supra* note 29, at 43, 59–60 (contending that open fields were receptive to technical progress and responsive to the introduction of new crops).

[76] These costs are the reason for Demsetz to generally disfavor commons. *See* Demsetz, *supra* note 13, at 357 ("(A)n increase in the communality of property and leads, generally, to an increase in the cost of internalizing.").

[77] *See* Sharman, *supra* note 24, at 47 (adding that the same time, peasants were subjected to negative externalities from others' fields, to trespass and other harm from negligent neighbors).

[78] With externalities internalized, the new owner of the wastes was likely to invest in them, and subject them to more intensive use. *See id.*; Roger B. Manning, *Patterns of Violence in Early Tudor Enclosure Riots*, 6 ALBION (A QUARTERLY JOURNAL CONCERNED WITH BRITISH STUDIES) 120, 123 (1974).

[79] The problem of small plots is caused by property rights themselves, not by their absence. It is therefore not part of Demsetz' models of property rights evolution.

[80] *See* Manning, *supra* note 79, at 120 (1974); Robert C. Allen, *Progress and Poverty in Early Modern Europe*, 56 ECON. HIST. REV. 403, 430 (2003); Vernon W. Ruttan & Yujiro Hayami, *Toward a Theory of Induced Institutional Innovation*, ("Toward a Theory of Induced Institutional Innovation," Discussion Paper No.200, 1984), *available at* https://conservancy.umn.edu/handle/11299/55371; KAIN et al., *supra* note 40, at 4.

[81] Allen, *supra* note 29, at 43 (reporting contemporary opinion). Thirsk, *supra* note 75, at 255 ("By 1640 few strong arguments could be advanced in favour of common fields and pastures").

[82] *See* Demsetz, *supra* note 13, at 353.

[83] These costs included not only the expenses of physical enclosure but of the process leading up to it. The political difficulties of enclosure, especially

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mained stable, enclosures would occur when the gains were greatest, i.e. when the expected rise in agricultural output would dramatically increase income: When the demand for agricultural products rose[84] (through population growth and urbanization[85]), when improvements in infrastructure allowed for broader commercial activity,[86] and when large farms became more profitable because labor costs had sunk.[87] They also occurred when changing demand made the inflexible open fields regime particularly costly.[88] All these external factors echo the Demsetzian account of property rights change.

C. Limitations of the Economic Perspective

In order to describe an economic chain of causation, the Demsetzian perspective purposefully limits its variables. It restricts our field of view, both on the causes of reform, and on its

concerning the distributional decisions associated with it, increased the costs of the process. *See* Yelling, *supra* note 73, at 414 (observing how these costs formed "a single large barrier to change"). The violence and prospective violence associated with enclosure also generated costs that hindered change. *See* Congost, *supra* note 73, at 94.

[84] The rise in prices preceding enclosure can be observed statistically. *See* Wordie, *supra* note 30, at 503; Sharman, *supra* note 24, at 47; KAIN et al., *supra* note 40, at 4. It is also mirrored in the coinciding rise of conflict over access to tenure and common rights. *See* ANDY WOOD, RIOT, REBELLION AND POPULAR POLITICS IN EARLY MODERN ENGLAND 87 (2001).

[85] On the rapid growth of population England witnessed beginning in the sixteenth century, see generally Manning, *supra* note 79, at 120. Parallel to the population growth, economic structure of society evolved, with an increasingly urban, proto-industrial economy creating an urbanized and well-paid population group. This group was not self-sustaining, instead relied on the rural populace to sustain it. *See generally* Allen, *supra* note 81, at 430.

[86] The open field system was well adapted to the conditions of medieval England, encouraging subsistence farming, and rendering villages economically independent of one another. This was necessary, as transport was bad and marketing opportunity few. *See* Sharman, *supra* note 24, at 46–7. With improvements in infrastructure, the villages increasingly were able to engage in commercial agriculture. *See* Richard Kaeuper, *Social Ideals and Social Disruption*, *in* THE CAMBRIDGE COMPANION TO MEDIEVAL ENGLISH CULTURE 87, 90 (Andrew Galloway ed., 2011).

[87] *See* Ruttan & Hayami, *supra* note 81, at 7; Clark, *supra* note 73, at 95.

[88] In particular the first great surge of enclosures in the 15th and 16th centuries seem to have been triggered by an increase in demand for wool. Sheep herding required greater pastures, a demand the inflexible open fields could not accommodate. The opportunity costs caused by the land regime thus rose, until they made enclosures economically viable. *See generally* Wordie, *supra* note 30, at 503; Thirsk, *supra* note 75, at 246.

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results. What if, in the often-cited Demsetzian example of Labrador fur trade,[89] fur hunters had socialized every now and then upon meeting in the forest? Some of them might for this reason have refrained from allotting separate hunting grounds. Others might have done so, but afterwards dearly missed the company. The economic perspective would capture neither phenomenon. The near-simultaneous evolution of the HRS in different parts of China[90] follows no apparent economic pattern.[91] Neither can the economic perspective explain the uneven pace of enclosure of English lands.[92] The economic view of the causes of property reform seems incomplete in both cases. Great social conflict resulted from the English enclosures,[93] disrupting rural society and dividing historians' opinion to this day.[94] The HRS in contrast "emerged quietly,"[95] and scholars seem near unanimous in sup-

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[89] *See* Demsetz, *supra* note 13, at 351–53.

[90] *See* Peter Ho, *In Defense of Endogenous, Spontaneously Ordered Development: Institutional Functionalism and Chinese Property Rights*, *in* RURAL POLITICS IN CONTEMPORARY CHINA 172, 188 (Emily T. Yeh et al. eds., 2015); Björn Alpermann, *Introduction to Politics and Markets in Rural China*, *in* POLITICS AND MARKETS IN RURAL CHINA 1, 4 (Björn Alpermann ed., 2011).

[91] *But see* JOSEPH FEWSMITH, DILEMMAS OF REFORM IN CHINA: POLITICAL CONFLICT AND ECONOMIC DEBATE 27 (1994) (arguing that the HRS came into existence where economic need was direct).

[92] *See* NEESON, *supra* note 77, at 5 ("Thus the earlier enclosure of southeastern England resulted . . . from the fact that enclosure was easier to achieve there."); KAIN et al., *supra* note 40, at 2 (contending that the economic explanations of enclosures "do not address the observable temporal and regional variations between 1700 and 1900"). *But see* Thirsk, *supra* note 75, at 246 (observing how pastoral countries, where land was not scarce, seemed to favor enclosure agreements); Wordie, *supra* note 30, at 503 (believing that enclosure was "delayed in fertile areas . . . where the existing farming system suited the soil type and the existing marketing conditions well enough").

[93] On the scale of resistance, *see* CARL J. GRIFFIN, *PROTEST, POLITICS AND WORK IN RURAL ENGLAND, 1700–1850*, 65 (2013) ("always generated resistance"); Humphries, *supra* note 39, at 21 (recounting "(w)idespread opposition to enclosure, even in the face of severe legal, economic, and social sanctions"); WOOD, *supra* note 85, at 82 (observing that "(o)nly in a minority of cases did enclosure lead to riot," even while enclosures were "the most common cause of riots during the sixteenth and early seventeenth centuries"). On the difficulty to ascertain the scope of conflict, see generally Griffin, *supra*, at 68.

[94] On the controversy surrounding enclosures, see generally Sharman, *supra* note 24, at 45 ("(N)o sooner has one writer proposed a solution than others are quick to rise up and disabuse him of his pretension."); Robert C. Allen, *Tracking the Agricultural Revolution in England*, 52 ECON. HIST. REV. 209, 210 (1999) ("Every generation rewrites history, and the treatment of the agricultural revolution is no exception.").

[95] FENG et al., *supra* note 70, at 2.

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porting it.[96] In its optimism,[97] the economic perspective is unable to account for this difference in reception.

D. Interest-Group Perspective?

Scholars have sought to supplement the economic perspective with studying interest group dynamics.[98] This political perspective tends to be more micro-oriented than its economic counterpart, describing motives, power, and bargaining processes, and contributing greatly to an understanding of the dynamics of property rights change.[99] A political view of Chinese reform would hold that the HRS occurred as the ideological pressure was eased.[100] It would add a description of power struggles within the Politburo, leading to the eventual acceptance of household-based agriculture.[101] A political account of the English reform would be more colorful, reporting how a powerful aristocracy,[102] seconded

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[96] They alone dispute whether the reform's step in direction of private ownership went far enough. For a positive account of the slow reform process, see HO, *supra* note 14, at 3; Putterman, *supra* note 17, at 1058.

[97] Saul Levmore notes how the economic perspective invariably produces an optimistic view of change, see Levmore, *supra* note 50, at 423, 428, 433. On the optimistic nature of reforms responding to external economic change, see generally Ellickson, *supra* note 3, at 550.

[98] *See* Wyman, *supra* note 2, at 167–84 (analyzing the group-dynamics between holders of taxicab licenses and the public in New York City); *see further* Levmore, *supra* note 50, at 429–32; LIBECAP, *supra* note 7, at 10; Porrini & Ramello, *supra* note 6, at 1.

[99] The political perspective is able to explain the persistent variety of property institutions witnessed in countries of similar economic circumstances. Porrini & Ramello, *supra* note 6, at 2. It is able to account for the persistence of "problematic property rights" that cause great inefficiencies. Wyman, *supra* note 2, at 186 (concluding that the New York City Taxicab Licenses are such property rights); LIBECAP, *supra* note 7, at 3 (observing more generally on such problematic cases in European history). Here they usually find what Elinor Ostrom calls "lock in," i.e. powerful individuals holding on to a certain regime creating problematic path dependence. Elinor Ostrom, *Developing a Method for Analyzing Institutional Change*, *in* ASSESSING THE EVOLUTION AND IMPACT OF ALTERNATIVE INSTITUTIONAL STRUCTURES 30 (Sandra Batie and Nicholas Mercuro eds., 2008), *available at* http://ssrn.com/abstract=997837).

[100] *See, e.g.*, FEWSMITH, *supra* note 92, at 25.

[101] *See, e.g.*, Peter Ho, *Introduction: The Chicken of Institutions or the Egg of Reforms?, in* DEVELOPMENTAL DILEMMAS: LAND REFORM AND INSTITUTIONAL CHANGE IN CHINA 1, 10–11 (Peter Ho ed., 2005).

[102] *See* Clark, *supra* note 73, at 75 (contending that the governing class in England was stronger than in continental Europe, and thus able to pursue the path of efficiency).

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by large landowners[103] contended with the remainder of the village, notably the landless laborers.[104]

While the interest-group perspective widens our understanding of Chinese and English reforms, it cannot answer my initial question. It illustrates the social conflict in England, yet cannot fully identify its origin. The interest groups narrative depicts property rights change as distributive conflicts, and its actors as motivated by economic gains.[105] Enclosures in particular had a strong distributive side, with large landowners (and landlords in particular[106]) gaining disproportionally. Nonetheless, the interaction between land reform and society is more complex. Firstly, reforms are shaped by how social relations enforce or dispute them.[107] Secondly, they impact social relations far more broadly and deeply than in redistributing resources. They may affect trust in communities, intra-family relations, or alter a whole societies' way of life.[108] Such interactions are neither captured in an economic nor in an interest-group perspective.

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[103] *See* Sharman, *supra* note 24, at 50 (observing how these were often the most resourceful, and most enterprising members of the village, and likely those most receptive to the gains macro-economic change put within their grasp).

[104] *See* Humphries, *supra* note 39, at 21; WOOD, *supra* note 87, at 83 (noting how wool producers at times fought the near-entirety of the village populace); Michael E. Turner, *The Cost of Parliamentary Enclosure in Buckinghamshire*, 21 AGRI. HIST. REV. 35, 37 (1973) ("very bitter struggle between the leading landowners and the poor of the parish").

[105] *See, e.g.*, Wyman, *supra* note 2, at 146.

[106] Competing with the efficiency-focused account of enclosure is one that focuses on landlords' gains in rent: The lord-tenant relation constituted a basic layer of English property rights. The tenant held a strong and stable legal position. While leases spanning decades at rents previously fixed provided stability, and while they were acceptable in stable economic environments, they were ill adapted to respond to economic change. Rising prices of agricultural products were not mirrored in rising rents. Tenants received a surplus, as rents were fixed below market value. This became particularly onerous to lords when prices peaked during the Napoleonic Wars. Enclosure acts annulled all leases. Economically, this was a great blessing to the lords, with scholarship widely accepting that rents increased dramatically post-enclosure. On this rent-focused account of enclosure, see Wordie, *supra* note 30, at 504; Clark, *supra* note 73, at 76; Clark & Clark, *supra* note 23, at 1033.

[107] For a critical account of interest groups scholarship along these lines, see Fitzpatrick, *supra* note 3, at 1046.

[108] *See* JOSEPH W. SINGER, ENTITLEMENT: THE PARADOXES OF PROPERTY 124 (2000).

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IV. SOCIAL RELATIONS PERSPECTIVE: AN INTRODUCTION

This paper will employ a social relations perspective on property rights. Property rights are relational. This sentence means different things to different people. Legal sociology views all law as social relations,[109] including property rights.[110] This perspective highlights how property rights and other social relations are part of a common network of interactions that constitutes society.[111] It blurs however the practical distinctions between legal rules and social norms.[112] I will therefore not share this assumption of legal sociology. I differentiate between law (governed by a lawful/unlawful distinction[113]) and other social relations (governed by distinctions of right/wrong, friendly/unfriendly etc.).

With this distinction in mind, we can base a relational perspective on property rights on relational contract theory. This theory considers (long-term) contracts to be legal relations embedded in complex social relations.[114] To understand a contract's working, as well as its potential to change gradually, requires a combined analysis of the formal contract and its relational surroundings.[115] A relational perspective on property rights thus holds that property rights are embedded in social relations, and

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[109] Legal sociology is the "scientific analysis of legal life as a system of behavior." Donald J. Black, *The Boundaries of Legal Sociology*, 81 YALE L.J. 1086, 1087 (1972). It views law as an object of the empirical world, as acts that have a social meaning to those observing them. *See id.* at 1091; Roger Cotterrell, *Why Must Legal Ideas Be Interpreted Sociologically?*, 25 J.L. & SOC'Y 171, 183 (1998).

[110] This seems to be the way in which Singer uses the term. *See supra* note 7, at 15.

[111] *See* Congost, *supra* note 73, at 74 ("Property relations, being social relations, must be observed from a plurality of angles").

[112] *See* Qiao & Upham, *supra* note 3, at 2490–91 ("(D)ifferent social control systems follow different logics, and we should not mix them, in particular, the social and legal relations").

[113] This distinction is drawn from Niklas Luhmann's System Theory, which distinguishes sub-systems of society according to the bi-partite code along which they distinguish real-world events. For Luhmann's treatment of the legal system, see NIKLAS LUHMANN, DAS RECHT DER GESELLSCHAFT 165–66 (1995).

[114] *See* Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 485–87 (1985); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 895 (1977–78).

[115] *See* Ian R. Macneil, *Relational Contract Theory: Challenges and Queries'*, 94 NW. U. L. REV. 877, 881 (2000).

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interact with them both when static and when changing. These assumptions will be developed in the following part.

A. What Are Social Relations?

A social relation consists of at least two persons influencing each other, affecting both the others' immediate reaction and his anticipation of future interaction.[116] Most human behavior is embedded in such relations.[117] They are dynamic, and they may change responding to their context.[118] Social relations may form collective patterns, which guide interactions in a group of people. A fist collective pattern examined below will be the sense of community. This is a fluid concept, developing around group relations marked by emotional safety, a sense of belonging, mutual acceptance and trust in the future stability of the community.[119] A second collective pattern will be the social norm, a "rule supported by . . . informal sanctions."[120] Informal sanctions will be understood in a broad sense. Social norms will therefore include collectively shared ideas of appropriate distribution (e.g., distribution of land in a village) and of dependence (e.g., the degree to which one household may depend on another).

B. Concert of Property Rights And Social Relations

An important pattern shaping social interaction is the allocation of entitlement. It "decide(s) which of the conflicting parties will be entitled to prevail."[121] Law creates rules that—often in assigning property rights[122]—govern a fraction of entitlements.[123] Much like law, social relations create rules: the social

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[116] On the efforts of relationship science to define relationships, see generally Harry T. Reis et al., *The Relationship Context of Human Behavior and Development*, 126 PSYCHOL. BULL. 844, 845 (2000).

[117] *See id.* at 844.

[118] *See id.*; Macneil, *supra* note 115, at 897.

[119] *See generally* David W. McMillan, *Sense of Community*, 24 J. COMMUNITY PSYCHOL. 315, 316–18 (1996).

[120] Ellickson, *supra* note 3, at 549 n.58 (noting that the definition of "social norm" remains highly disputed).

[121] Guido Calabresi & Douglas A. Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1090 (1972).

[122] *See id.*

[123] *See* Ellickson, *supra* note 3, at 540 (observing that the greatest part of entitlements is assigned through social relations).

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norms. Social norms may often govern the same entitlement as property rights: A farmers' cabbage plot is protected from his neighbor's lust for cabbage both by property rights and by social norms.[124] Thus, social norms and formal law govern society in concert.

Where social norms and property rights overlap, parties tend to rely on the former:[125] The social norm may be easier to ascertain than the legal rule, it may be more appealing, or parties may find it appropriate to solve their problems without resorting to law.[126] Hence, even when property rights are clear, parties may follow a quite different rule. And even where they follow the rule proposed by property rights, they will often do so motivated by social relations: Because property rights can be legally enforced only in marginal cases, where the interests at stake merit the procedural costs, their effectiveness relies on social relations ("informal enforcement"[127]).[128] Even where formal property rights are wholly absent, social relations can still effectively govern questions of entitlement:[129] The farmer's neighbor may still restrain his hunger for cabbage for fear of social sanctions,

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[124] *See id.* at 541.

[125] *See id.* at 540.

[126] *See id.* at 544 (observing how in the circumstances of a landlord-tenant relation, where stakes are low and the relation is long-term, parties are likely to rely on social norms rather than formal law). Ellickson supports his point empirically by pointing out how the legal introduction of an implied warranty of habitability, despite bringing with it a significant legal change, impacted little the actual problem-solving in landlord tenant disputes.

[127] *Id.* at 540 ("(T)he glue of a society comes not from law enforcement, as the classicists would have it, but rather from . . . unofficial enforcers (that) use punishments such as negative gossip and ostracism to discipline malefactors and bounties such as esteem and enhanced trading opportunities to reward the worthy.").

[128] *See* Andrzej Rapaczynski, *The Roles of the State and the Market in Establishing Property Rights*, 10 J. ECON. PERSP. 87, 88 (1996) ("The core of the institution of ownership is a matter of unquestioned and largely unconscious social and economic practices that must be rooted in non-legal developments."). *See similarly* DE SOTO, *supra* note 3, at 181; Qiao & Upham, *supra* note 3, at 2492; Daniel W. Bromley, *Property Rights and Land in Ex-Socialist States: Lessons of Transition for China*, *in* DEVELOPMENTAL DILEMMAS: LAND REFORM AND INSTITUTIONAL CHANGE IN CHINA 31, 37–38 (Peter Ho ed., 2005). In this, property rights share the fate of the legal system as a whole. *See* Thomas B. Stoddard, *Bleeding Heart: Reflections on Using the Law to Make Social Change*, 72 N.Y.U. L. REV. 967, 971 (1997) (studying how in cases of "disjunction between . . . laws and its underlying culture" the latter will prevail in shaping social interaction).

[129] *See* Qiao & Upham, *supra* note 3, at 2492.

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even where he must not fear state intervention.[130] Such informal regimes are empirically observed where formal property rights have not yet evolved, or where they are not effective.[131]

C. Social Relations Form Property Rights

In accordance with Eugen Ehrlich's observation that "(t)he center of gravity of legal development lies . . . in society itself,"[132] social relations are likely to shape property rights.[133] While the law is a system distinct from other social relations, parts of it are designed to be receptive to them. Receptiveness of property law rules (e.g., of adverse possession and prescriptive easements[134]) responds directly to social relations. Receptiveness of constitutional law (e.g., the rules of legislation) ensures that social relations shape the making of property law.[135] This receptiveness lets formal law react to the evolution of informal proper-

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[130] *But see* Calabresi & Melamed, *supra* note 122, at 1091 ("If Taney owns a cabbage patch and Marshall, who is bigger, wants a cabbage, he will get it unless the state intervenes."). For a critique of this account, see Ellickson, *supra* note 3, at 541.

[131] *See* Fitzpatrick, *supra* note 3, at 1011 (studying the evolution of non-state property rights in developing countries where resource government is conducted through "close-knit kinship networks that predate the creation of the modern nation-state").

[132] EUGEN EHRLICH, FUNDAMENTAL PRINCIPLES OF THE SOCIOLOGY OF LAW (GRUNDPRINZIPIEN DER RECHTSSOZIOLOGIE) xiv (1936) (adding that it hence lies "not in legislation, nor in juristic science, nor in judicial decisions.").

[133] *See* Porrini & Ramello, *supra* note 6, at 3 (contending that property rights "serve as a sort of map through which we can infer the socially shared value system of a specific human group").

[134] *See* Joseph W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 673 (1988).

[135] How social relations shape the making of property law is described in the interest groups narrative of property rights change identified above. *See, e.g.*, Wyman, *supra* note 2, at 146 (identifying the state as but a "vehicle through which individuals and groups act to create, maintain and transform property rights").

The influence of social restrains on governments has been studied in particular to governmental land takings (eminent domain). *See* Rapaczynski, *supra* note 130, at 93 ("(P)ressure groups that ensure that the state does not go 'too far' in interfering with the owner's control over assets. This politically determined thin line may be understood as the real definition of property rights conferred.") *See further* Naomi R. Lamoreaux, *The Mystery of Property Rights: A U.S. Perspective*, 71 J. ECON. HIST. 275, 296–97 (2011) (observing how the aftermath of *Kelo v. City of New London*, 545 U.S. 469 (2005) illustrated the restrictions social relations place on the U.S. government's exercise of eminent domain).

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ty rights, disputing[136] or incorporating them.[137] The workings of such property rights reform induced by relational change will be studied below.

D. Property Rights Form Social Relations

Where the state institutes property rights, social norms will likely be affected. The law can exert a transformative "culture-shifting"[138] power on society, provided that it is considered generally legitimate.[139] While we may identify a dominance of social norms over property rights in shaping social reality,[140] their relation is better considered reciprocal than one-sided. If a "fundamental thing law does"[141] is to decide on entitlement, then to assign property rights is perhaps the most visible way to do so.[142] Property rights decide on entitlement in attributing a degree of control over a resource to a person. It is for this reason that property law decisions have long been understood as decisions on distribution, and therefore on incentives.[143] However, many other social relations depend on the question of resource distribution: It affects both individual relations between two parties (in deciding on power[144], dependence,[145] and responsibility[146]) and societal relations as a whole (in shaping a society's way of life).[147]

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[136] As the English government had at first discouraged enclosures (*see infra* at V.B.2), and the Chinese explicitly banned the HRS (*see infra* at V.A.2).

[137] *See* Qiao & Upham, *supra* note 3, 2490–91.

[138] *See generally* Stoddard, *supra* note 129, at 982 (observing how the effect of New York and Parisian laws that ban smoking were highly dependent on history and culture).

[139] Such legitimacy does not imply full support for the new law by the majority of the populace, but merely "an aura of moral and cultural legitimacy" that can arise from a number of sources (e.g., procedural legitimacy). *Id.* at 982–83.

[140] *See* Qiao & Upham, *supra* note 3, at 2492.

[141] Calabresi & Melamed, *supra* note 122, at 1090.

[142] The importance of property rights in their framework is such that it has even served Guido Calabresi and Douglas A. Melamed in naming one half of their property/liability rule dichotomy, since "much of what is generally called private property can be viewed as an entitlement which is protected by a property rule." *Id.* at 1105.

[143] *See* Fitzpatrick, *supra* note 3, at 1008–09 ("Property rights are both a result and a cause of resource conflicts"); LIBECAP, *supra* note 7, at 11; Singer, *supra* note 7, at 3, 11 ("The historical practice of use property law contains principles that promote . . . distributive justice within concept and institution of property itself.").

[144] *See* LIBECAP, *supra* note 7, at 1.

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V. RELATIONAL PERSPECTIVE ON REFORM PROCESS

Property law reforms differ widely in their process. The Demsetzian perspective takes such differences in account only where they entail a difference in cost of reform.[148] Interest groups theories have broadened our understanding where reforms are the product of struggling interests. I will add an account of how social relations shape the process of reform. In describing Chinese and English land reform from this perspective, I can identify aspects of the process that caused, and others that avoided conflict. I begin by developing a framework to study the relational side of reform processes. I draw from the above overview of the interaction of law and relations, from Ian R. Macneil's relational contract theory,[149] and from Shitong Qiao and Frank Upham's theory of relational property.[150]

Theories of institutional change offer a distinction of imposed and induced process:[151] Imposed change is a top-down legislative reform, associated with uniform and abrupt change. Induced change is driven by the rights holders bottom-up, associated with uneven and gradual change. This second process is of interest here. Social relations offer a way to induce property rights change. The theory of relational contracts can explain how. As seen above, relational contract theory considers contracts to be embedded in social relations. These social relations are dynamic,

[145] *See, e.g.*, the increased dependence of landless laborers on their landed peers, or of wives on their husbands in post-enclosure England, *infra* at VI.B.2.

[146] For a historical example, see A. J. POLLARD, LATE MEDIEVAL ENGLAND 1399–1509 190 (2000) (observing on the medieval duty in England for wealthy villagers to hand out alms). For an example in contemporary constitutional law, see Article 14 of the German Basic Law ("Property entails obligations. Its use shall also serve the public good.") For an example in legal theory, see Singer, *supra* note 7, at 13–5 (proposing a duty to "use . . . property so as not to cause harm or let others down who rely on (it)").

[147] *See* Singer, *supra* note 7, at 8; *see further* the account given below on the impact on the sense of community, *infra* at VI.A.2 and VI.B.3.

[148] *See, e.g.*, Demsetz, *supra* note 13, at 353.

[149] *See* Macneil, *supra* note 115, at 895–97;Macneil, *supra* note 115, at 485–87 (1985).

[150] *See* Qiao & Upham, *supra* note 3, at 2491–93.

[151] The induced/imposed divide distinguishes change brought about by those immediately subject to it (induced) from that brought about by a higher authority (imposed). It features prominently in Elinor Ostrom's assessment of institutions, and has been refined by Lin for discussion of the Chinese property rights reform. *See* Ostrom, *supra* note 100, at 28; FENG et al., *supra* note 70, at 5.

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likely to evolve over time.[152] Their evolution can adjust the interaction between the parties: Even when the contract's legal content remains unaltered, the law in action will likely be modified by the social relations surrounding it, filling holes where the contract leaves a vacuum or altering the contract responding to new developments.[153] Parties may rely on their social relation rather than the initial contract to resolve the conflict between desire for change and their need for stability.[154] Relational contract theory encourages parties to embrace such gradual transformation, rather than seeking radical and swift changes.[155] Only through horizontal and non-confrontational means (e.g., negotiation and mediation) may parties successfully and harmoniously alter their relations.[156]

Qiao and Upham suggest applying relational contract theory to the process of property rights reform.[157] Based on the interrelation between property rights and social relations depicted above, this creates the following narrative: Property rights are embedded in social relations. Social relations are dynamic.[158] Where they evolve, they change the law in action of property rights, creating purely "relational property."[159] As social relations are reciprocal, such changes tend to rely on the rights holders' mutual willingness to transform their property relations (i.e. they follow a "property rule"[160]). Changes are therefore likely to affect few villagers at first, but will then gradually spread in a community.[161] Originally evolving in one community, relational property

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[152] *See* Macneil, *supra* note 115, at 897.

[153] *See id.* at 895–96; Macneil, *supra* note 116, at 881.

[154] *See* Qiao & Upham, *supra* note 3, at 1491.

[155] *See* Macneil, *supra* note 115, at 897 ("(H)armonization is unlikely to come through revolutionary changes").

[156] *See id.* at 895, 897.

[157] *See* Qiao & Upham, *supra* note 3, at 2491.

[158] On different theories of how social norms change, see generally Ellickson, *supra* note 3, at 550.

[159] LIBECAP, *supra* note 7, at 11 (explaining how private bargaining will "assign or adjust informal ownership arrangements"). For an introduction to the term relational property, see Qiao & Upham, *supra* note 3, at 2491.

[160] For the distinction of property and liability rule, see Calabresi & Melamed, *supra* note 122, at 1092.

[161] Calabresi and Melamed (amongst others) demonstrate that where property rights change affects the entitlements of a large number of people, it usually cannot proceed based on the property rule (each owner fixes his price), but will have to rely on liability rule (price objectively fixed), i.e. state intervention (in their framework, eminent domain). *See id.* at 1106–07.

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can be replicated in others.[162] The pace of change will be uneven, responding to relational, rather than economic, differences. As according to relational contract theory the relation will depart from the contract's text, the relational property will conflict with formal law.[163] Over time however, these informal property changes may induce a reform of the formal property law.[164]

Just as the theory of relational contracts suggest with regard to a transformation of contracts, relational transformation of property rights is likely to be harmonious: Firstly, the legal changes thus created are less likely to dispute existing social relations. Secondly, and purely procedurally, the process of reform will less likely cause conflict because it is embedded in social relations. Relational contract theory suggests that relational change leaves the social relations intact, embedding the new order in pre-existing social relations and softening alterations.[165] It will follow established lines, and build on, rather than destroy, trust in the community.[166] It hence seems to offer a way to balance the need for property rights stability and change.[167]

In the following part I use this framework to study the process of Chinese and English property reforms. Initially, both followed inductive, relational lines. In the Chinese experience, the reform spread by voluntary analogy, and only its consolidation was conducted in a (cautious) top-down process. In the English case, initially the enclosures were also conducted through

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[162] *See* DE SOTO, *supra* note 3, at 190 (citing the analogous spread of folk customs); Fitzpatrick, *supra* note 3, at 1040 (observing a competition between a plurality of informal governance mechanisms); Qiao & Upham, *supra* note 3, 2501 (describing the replication of small property rights in Shenzhen, China). On the potential of such social-relations induced change to spread beyond close-knit communities, see *id.* at 2493–95.

[163] For such an account of the relational evolution of small property rights in Shenzhen defying formal property law, *see* Qiao & Upham, *supra* note 3, at 2501 (2015).

[164] *See id.* at 2490–91.

[165] For the potential struggles associated with change, see LIBECAP, *supra* note 7, at 3–4; Fitzpatrick, *supra* note 3, at 1009 (contending that Demsetzian theories of property rights change overlook such costs of distributional struggles caused by property rights reform).

[166] *See* SINGER, *supra* note 110, at 124.

[167] *See* Qiao & Upham, *supra* note 3, at 2491; *see similarly* Lamoreaux, *supra* note 136, at 296–97 (studying how the power of social relations serves to counter-balance governmental authority of eminent domain (and its exercise) in the U.S. to create property rights stability while allowing for the government to have such authority).

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social relations, and spread through replication. When however the relational process met limitations, top-down parliamentary enclosure took its place. This legislative part of the reform caused bitter conflict.

A. China, Relational Process

1. Initial Adaptation of HRS

Because relational processes widely follow a property rule vulnerable to individual opposition, they favor gradual change: Individual opposition is overcome more readily where enterprising individuals may set examples later copied by their more risk-averse peers.[168] At first sight, the HRS appears therefore to be an unlikely institution to be introduced through relations. Its introduction affected all villagers at once, and in a sudden manner. It necessitated not only the distribution of land (the shares to which were easily computable), but also of other assets such as farm tools, which pre-reform had been owned individually in some parts and collectively in others.[169]

Nonetheless, the HRS seems to have been the product of a property rights change induced by social relations, a change "worked out among farmers."[170] Chinese villages historically were close-knit communities, a tendency reinforced by the Production Team System choosing the natural village as basic unit of economic production.[171] In the decades before the reform, villages' economic and social activities had become increasingly self-contained.[172] Comprising ten to fifty households, production teams chose their own leadership and were used to collectively make decisions related to land use.[173] These social and cultural

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[168] Such pioneers can only appear where individuals may shape property rights without involving the whole community, as witnessed in the development of small property rights housing in China. *See* Qiao & Upham, *supra* note 3, at 2503.

[169] *See* Travers, *supra* note 70, at 243.

[170] *See* Justin Yifu Lin, *The Household Responsibility System in China's Agricultural Reform: A Theoretical and Empirical Study*, 36 ECON. DEV. AND CULTURAL CHANGE 199, 201 (1988).

[171] *See, e.g.*, Day, *supra* note 67 at 937; HUAIYIN LI, VILLAGE CHINA UNDER SOCIALISM AND REFORM: A MICRO HISTORY, 1948–2008 6 (2009); Qiao, *supra* note 22, at 123–24.

[172] *See* Day, *supra* note 67, at 937.

[173] *See id.*

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networks seem to have enabled a spontaneous evolution of the HRS, a "change by consensus"[174] chosen by villagers themselves as soon as it became politically viable.

Relational evolutions are characterized by their gradual, tentative, and decentralized progress. In 1978, various localities simultaneously experimented with new land regimes, creating "spontaneous property institutions."[175] Different models were developed in different villages.[176] The variant of today's HRS seems to have appeared first in Xiaogang village in Anhui province, then a community "driven by hunger and despair."[177] Typical of relational change, the HRS spread to other villages by replication: The experimenting counties in Anhui province brought in harvests far greater than neighboring counties not involved in experiments.[178] Consequently, other collectives copied their models, varying and adapting it to fit local preferences.[179] Mirroring the overall pattern of Chinese economic reforms,[180] the HRS thus spread over the countryside unevenly, long avoiding collectives where it was difficult to implement for relational or economic reasons.[181]

2. Consolidation of HRS

When and how the state was involved in introducing the HRS is a matter of dispute.[182] I will here give an account as it is

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[174] *E.g.*, Gelb et al., *supra* note 69, at 124–25; Huang, *supra* note 16, at 197.

[175] Huang, *supra* note 16, at 197.

[176] *See, e.g.*, Alpermann, *supra* note 91, at 4; Korff, *supra* note 15, at 411–12.

[177] LI, *supra* note 172, at 267–68 (offering a detailed version of the commonly accepted account of the decision-making process that led the village to adopting the HRS, while also citing doubts on its accuracy). This event was commemorated in a visit to Xiaogang of Hu Jintao, the then General Secretary of the Communist Party of China, on September 30, 2008.

[178] *See, e.g.*, Lin, *supra* note 171, at 201.

[179] *See, e.g.*, Korff, *supra* note 15, at 411–12 (observing how "counties . . . varied their use of large-scale and small-scale (or family-centered) farming to meet different levels of demand," and that the "precise implementation of HRS varied from province to province, even county to county, . . . explaining the gradual and incomplete adoption of the system."); Ho, *supra* note 102, at 10–11.

[180] *See* Gelb et al., *supra* note 69, at 87.

[181] *See* Lin, *supra* note 63, at 412–14 (describing how the distribution of machinery proved the most difficult, and illustrates how this difficulty statistically delayed the introduction of the HRS).

[182] The majority of scholars describe the introduction of the HRS as one conducted either without or against the government. *See, e.g.*, Lin, *supra* note 171, at 201; FEWSMITH, *supra* note 92, at 27; Ho, *supra* note 102, at 10–11. This

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commonly told. The central government had recognized the incentive problems marring production teams, and in December 1978 proposed reforms to strengthen the work point system.[183] It did not however seek to change property rights relations: Control and residue rights to the land were to remain collective, and in September 1979 conferring them to households was expressly forbidden as being the "reverse of the socialist principle of collective farming."[184] Of the experiments conducted on the countryside the central government was at first unaware and later merely tolerant.[185] The provincial and local governments, notably that of Anhui governor Wan Li, were protective at most.[186]

The increase in output reported by collectives experimenting with HRS, together with Anhui governor Wan Li's promotion to the Politburo, gradually led to the HRS being endorsed by the central government.[187] In 1980, the central government acknowledged and approved of the HRS' existence, while at first restricting it to remote and poor regions.[188] This restriction could not prevent the relation-induced spreading of the HRS to prosperous regions.[189] In late 1981, when 45 per cent of Chinese collectives

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is also the account promoted by the Chinese central government itself, beginning with Deng Xiaoping naming the HRS "a great invention of Chinese farmers." *E.g.*, People.cn, *News of the Communist Party of China* (Oct. 10, 2008, 9:17 AM), *available at* http://english.cpc.people.com.cn/66102/6512746.html; China Daily, *Business Weekly* (Mar. 3, 2008, 7:20AM) *available at* http://www.chinadaily.com.cn/bw/2008–03/03/content_6500748.htm. Other scholars describe a more immediate and decisive involvement of the central government. *See, e.g.*, LI, *supra* note 172, at 268 (offering a general criticism of this perception of bottom-up evolution, arguing that the de-collectivization in rural China was "primarily a top-down process planned and imposed by the state, rather than a result of local initiatives"); DAVID GALE JOHNSON, THE PEOPLE'S REPUBLIC OF CHINA: 1978–1990, 30–31 (1990).

[183] Propositions made in the Third Plenary Session of the Eleventh Central Committee of the CPC in December 1978. *See* Lin, *supra* note 171, at 200–01.

[184] *See id.* (citing a document issued by the Fourth Plenary Session of the Eleventh Central Committee of the CPC in September 1979).

[185] *Id.* at 201.

[186] *See, e.g.*, Ho, *supra* note 102, at 10–11 (observing on the tacit support of the provincial government); FEWSMITH, *supra* note 92, at 27 (reporting "neither approval nor disapproval" from the side of the district party secretary); Alpermann, *supra* note 91, at 4.

[187] *See* Ho, *supra* note 102, at 10–11.

[188] *See, e.g.*, Travers, *supra* note 70, at 243; Lin, *supra* note 171, at 201 (1988); JOHNSON, *supra* note 183, at 31.

[189] *See, e.g.*, Lin, *supra* note 171, at 201; Ronald I. McKinnon, *Spontaneous Order on the Road Back from Socialism: An Asian Perspective*, 82 AM. ECON.

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had already adopted the HRS, it was at last approved as a nationally acceptable institution.[190] This shift in policy met little resistance by local governments, and by the end of 1983, 98 per cent of collectives had embraced the HRS.[191] The following decades saw a cautiously proceeding top-down consolidation of the HRS,[192] until in 2002 the HRS was regulated in greater detail in Chapter II of the RLCL.

B. England, Relational Process

1. Enclosure Agreement

Enclosure by agreement predated enclosure legislation, and dominated land reform in rural England until 1700.[193] Its extent is uncertain, though consensually described as significant.[194] Like the HRS, enclosures appear an unlikely outcome of relational property rights change. Enclosure agreements were in their effect similar to top-down parliamentary enclosure: They usually concerned the whole of the village land, either specifying its repartitioning in the agreement itself or deferring this decision to a neutral third party (the commissioners) appointed in the agreement.[195]

REV., 31, 33 (1992); JOHNSON, *supra* note 183, at 31 (observing that until 1990 the central government had not publicly modified this policy).

[190] *See* Lin et al., *supra* note 62, at 213.

[191] *See* Nee & Sijin, *supra* note 15, at 6 (reporting "opposition and foot-dragging of rural cadres in the early stages of the reform"). The bumper harvest of 1984 silenced the last skeptics who had previously warned against the HRS, and triggered the extension of the HRS to non-crop-building agricultural sectors. *See* Ho, *supra* note 102, at 11.

[192] *See* HO, *supra* note 102, at 3 (citing "the state's deliberate choice to shroud certain institutions in a mist of indeterminacy").

[193] *See*, *e.g.*, Sharman, *supra* note 24, at 47–48; Shaw-Taylor, *supra* note 23, at 641.

[194] There is consensus that parliamentary enclosure affected no more than a third of English land. *See* John Chapman & Sylvia Seeliger, *Formal Agreements and the Enclosure Process: The Evidence from Hampshire*, 43 AGRIC. HIST. REV. 35, 35 (1995). As in 1850 virtually all rural land was enclosed, the agreements must have been more important than the acts, or else important parts of England must never have been subject to the open fields system. *See* Clark & Clark, *supra* note 23, at 1010.

[195] The commissioners effected the readjustment of land in the village. All villagers who had any legal interest in the land to be enclosed were to present their interest in writing to the commissioners. Where other villagers objected to a claim raised, it was the commissioners' task to gather evidence and judge on

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Nevertheless, a relational model seems well suited to explain the enclosures' evolution. The pre-enclosure property rights regime was embedded in a strong and complex net of social relations marked by mutual cooperation. Villages were close-knit communities and the villagers were used to collective decision making in managing their commons.[196] Besides their ties to others in the same village, many villagers had developed relations on a regional scale. Villagers frequently migrated within the same region[197] and village lords profited from a powerful regional and national social network.[198] According to social contract theory, these relations should gradually allow formal law to evolve, with individual relations inducing broad property rights reform: Agreements relied on the common assumption that enclosures were an improvement for the whole village to profit from. This required proponents of enclosure to proceed cautiously. They had to achieve mutual understanding, and to convince fellow villagers of the benefits of enclosure. Village lords, who were to gain much from enclosing, seem to have been pioneers, gradually impressing their views on the landed peasantry in the village, and effecting a change in attitude both in village communities and society at large.[199] Where poorer peasants were forced to sell their plots in times of hardship, the ensuing accumulation of village land in the hands of few greatly aided this development: It homogenized the relevant social groups and diminished their size, facilitating relational property rights change.[200]

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its validity. Based on the claims judged to be valid, the commissioners allotted land following the principles of the enclosure act. On appointment and role of the commissioners, see Sharman, *supra* note 24, at 58–62.

[196] *See* Thirsk, *supra* note 75, at 255.

[197] *See* J. A. SHARPE, EARLY MODERN ENGLAND: A SOCIAL HISTORY 1550–1760 91 (1997).

[198] For an impression of how the way of life of gentry and nobility afforded them ample opportunity to exchange ideas, see Wallace T. MacCaffrey, *England: The Crown and the New Aristocracy, 1540–1600*, PAST & PRESENT, 52–54 (1965). In the relational development of enclosures, the village lords may have acted as what Shitong Qiao and Frank Upham call the "'supernodes' of the society (that) transmitted the information and practices to other communities." Qiao & Upham, *supra* note 3, at 2501.

[199] *See* Thirsk, *supra* note 75, at 254.

[200] *See* BRADLEY, *supra* note 30, at 46 (contending that enclosure was only necessitated when landlords were "to lose patience with the process which was gradually eliminating the poorer men"). At times, such accumulation reached the extreme case of one or a group of villagers holding the entirety of village

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2. Enclosure Acts

How the enclosures digressed from the existing order can be felt in the English government's initial resistance to them. During the late 15th to mid-17th centuries it pursued an "active anti-enclosure policy."[201] As enclosures by agreement nonetheless caused a gradual property rights reform in the countryside, they slowly earned public and government support.[202] At the same time, enclosure by agreement of the remaining commons proved more and more difficult.[203] This marked the beginning of a transformation from enclosure agreements to enclosure acts. As agreements were limited by the requirement of unanimity,[204] and at times by enforcement difficulties,[205] the government introduced acts to broaden the successes of agreements. Gradually, governance replaced negotiation as the driving force behind enclosure. The first enclosure acts merely confirmed prior agreements, yet soon the acts *were* enclosure: They determined the area to be enclosed and appointed the commissioners that were to implement them.[206]

The first enclosure act was passed as early as 1604[207] or 1606, [208] yet not until 1750 "the slow trickle of acts turned into a

property rights. The then meaningless common rights ceased to exist, and an "informal enclosure" was effected.

[201] *See, e.g.*, WILLIAM E. TATE, THE ENGLISH VILLAGE COMMUNITY AND THE ENCLOSURE MOVEMENTS 125 (1967) (focusing on the time of 1607 to 1636); J. M. ANDERSON, THE HONORABLE BURDEN OF PUBLIC OFFICE: ENGLISH HUMANISTS AND TUDOR POLITICS IN THE SIXTEENTH CENTURY 63 (2010) (focusing on the mid-16th century); HAMMOND & HAMMOND, *supra* note 25, at 10 (for the time during 1490 to 1601).

[202] For a classical account on how governments slowly came to accept the supremacy of land ownership, see HENRY GEORGE, PROGRESS AND POVERTY (ABRIDGED VERSION OF THE FIRST EDITION FROM 1880) 208–209 (Bob Drake ed., 2006).

[203] *See* HAMMOND & HAMMOND, *supra* note 25, at 10.

[204] *See, e.g.*, Brown & Sharman, *Enclosure: Agreements and Acts*, 15 J. LEGAL HIST. 269, 273–74 (1994) (finding in empirical research that only in few cases would the judiciary compel the opponents to enclosure to yield to the majority); Yelling, *supra* note 73, at 414 (reporting how the difficulty of finding general support long deterred enclosures in the English midlands).

[205] *See* Brown & Sharman, *supra* note 205, at 277.

[206] *See* Sharman, *supra* note 24, at 63.

[207] *See* Thompson, *supra* note 31, at 624.

[208] *See* Sharman, *supra* note 24, at 47–48.

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flood."[209] By 1760, enclosure acts had attained a standardized form.[210] The procedure of passing enclosure acts marked a departure from relational property rights change. The process was bottom-up at first, requiring a petition from villagers.[211] As the parliament would then consider popular opposition to the project, petitions were preceded by a time where landowners in the parish investigated their fellow villagers' opinions, and might even seek to pre-empt opposition by buying dissenters' property.[212] While this phase was strongly relational, governance marked later stages: A parliamentary committee heard proponents and, if present, opponents of the project, calculated the interests for and against enclosure, and then decided—always conscious of the well-known benefits of enclosure.[213] The contemporary and historical reception of the fairness and inclusiveness of this process is divided, yet there is consensus that it was marked by top-down decision making with little regard for community relations.[214]

C. Comparative View

The Chinese land reform largely followed a relational impulse. Only its consolidation in later years was steered in cautious

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[209] Thompson, *supra* note 31, at 624. *See also* Shaw-Taylor, *supra* note 23, at 641; Clark & Clark, *supra* note 23, at 1034; HAMMOND & HAMMOND, *supra* note 25, at 10.

[210] *See, e.g.*, Sharman, *supra* note 24, at 48; KAIN et al., *supra* note 40, at 6 ("In the final analysis, the decision to enclose always lay in the hands of local interested parties.").

[211] To introduce an act into parliament, anyone could petition for it, granted he had legal counsel to assist him in drafting the petition. In practice, petitioners were usually an alliance of landowners in the area interested in enclosure. *See, e.g.*, HAMMOND & HAMMOND, *supra* note 25, at 19; Sharman, *supra* note 24, at 49 (noting that indeed the only sensible way to commence proceedings was to form such a coalition of willing landowners, as the petitioners must have had sufficient sway to overcome opposition likely to be voiced).

[212] *See* Turner, *supra* note 105, at 36.

[213] Scholars agree that the selection of the committee members typically ensured not their lack of vested interest, but on the contrary, their local connections and interest in the process and its outcome. *See, e.g.*, Sharman, *supra* note 24, at 52; Turner, *supra* note 105, at 38 ("reporting of later enclosures that 'Parliament was now favoured so much towards enclosure that it was difficult to find a member to oppose it.'").

[214] For cases where wealthy landowners made used that wealth to their advantage in procedure, see, e.g., Turner, *supra* note 105, at 37; WOOD, *supra* note 85, at 83; Humphries, *supra* note 39, at 34 (observing "class-biased casuistry of this committee"); HAMMOND & HAMMOND, *supra* note 25, at 12 ("A dictatorship lends itself more readily to the quick introduction of revolutionary ideas.").

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top-down legislation. The English enclosures too ran along relational lines at first. However, this approach was later replaced by strongly top-down parliamentary enclosure. Does this explain the diverging patterns of conflict? While recent decades saw bitter land-related conflicts in China,[215] the introduction of the HRS did not witness such tensions.[216] Similarly, enclosure by agreement has not been accompanied by conflict: "Friendly agreements . . . took the sting out of the enclosure movement,"[217] creating a gradual property rights change that "ran smoothly,"[218] "silently and painlessly."[219] Enclosure agreements caused so little conflict that their magnitude is difficult to ascertain today.[220] Not until the advent of parliamentary acts did conflicts increase. This indicates that the root of social conflict lies not alone in property rights *change*, but also in the contrast of relation-induced and legislation-imposed *process*. It confirms the assumption that a relation-induced property rights reform is likely to be less conflicted.

VI. RELATIONAL PERSPECTIVE ON PROPERTY RIGHTS CHANGE

In describing the changes property reforms entail, an economic perspective focuses on efficiency. An interest-group perspective provides an account of the reforms' impact on resource distribution. To this picture, I will add a relational approach. In order to identify the causes of social conflict, I will study how in China and England the pre- and post-reform property rights interacted with social relations. I begin by developing a framework on how property rights change affects social relations, and how social relations in turn shape the outcome of property rights change. I draw from the introduction above, as well as from

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[215] For a general account, see Dean & Damm-Luhr, *supra* note 14, at 131 (reporting that land related conflicts have been the primary source of Chinese rural unrest in recent years). For an individual case study, see Eva Pils, *Land Disputes, Rights Assertion and Social Unrest: a Case from Sichuan*, 19 COLUM. J. ASIAN L., 235, 273–83 (2005).

[216] *See* Ho, *supra* note 102, at 2 (contrasting the Chinese reforms favorably with those in post-communist Eastern Europe). *See* Huang, *supra* note 16, at 194.

[217] Thirsk, *supra* note 75, at 255.

[218] *Id.* at 254.

[219] *Id.* at 246. *See also* BRADLEY, *supra* note 30, at 45.

[220] *See, e.g.*, Chapman & Seeliger, *supra* note 195, at 35–36; WOOD, *supra* note 85, at 82–83 ("Many enclosures were uncontroversial and so often went undocumented.").

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Hernando de Soto's[221] and Daniel Fitzpatrick's[222] accounts of property rights reform in developing countries.

The above observations on the interplay between social relations and property rights suggest a number of assumptions on property rights change: Property rights and social norms can make concurring or disputing decisions on the same questions of entitlement. Since either side can form the other, a contradiction will either weaken property rights, or social relations, or both. Since social interactions are usually governed by a concert of social relations and property rights, their disagreement will likely cause social conflict. These assumptions may be illustrated in four ideal-typical outcomes of a dispute between property reform and social relations: (1) Property law prevails, altering social relations to henceforth support the new formal legal order.[223] This variant will likely cause grievances among those who relied on the pre-reform order, potentially breeding conflict. (2) Social norms prevail, rendering existing property law ineffectual (dead letter law).[224] This variant is not prone to conflict, as it does not affect social relations. (3) Social norms and property law are both effective with neither attaining a clear primacy, allowing for "legal institution shopping."[225] (4) Social norms and property rights destabilize each other, leaving a vacuum of governance.[226]

Hernando de Soto and Daniel Fitzpatrick both draw a normative conclusion from these observations. They suggest that property rights changes should be aligned with the existing "ex-

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[221] *See* DE SOTO, *supra* note 3, at 174–84.

[222] *See* Fitzpatrick, *supra* note 3 , at 1011–15.

[223] This is the case in most property reforms in societies governed by a well-functioning legal order. Where the alteration is considerable, it will likely cause grievances through this sudden change of social norms. On the power of communities' reliance on a certain property rights order, see generally Singer, *supra* note 135, at 622–23.

[224] *See, e.g.*, DE SOTO, *supra* note 3, at 178–79 (citing land formalization campaigns in Peru); Fitzpatrick, *supra* note 3, at 1012 (recounting similar failures of property rights reform in developing countries generally); Ho, *supra* note 92, at 183; Shitong Qiao, *Small Property, Adverse Possession and Optional Law*, *in* LAW AND ECONOMICS OF POSSESSION 266, 290–91 (Yun-chien Chang ed., 2015) (citing the resilience of so-called small property rights housing in China).

[225] Fitzpatrick, *supra* note 3, at 1015 (commenting on how such dual governance system cause great uncertainty and conflict).

[226] *See id.* at 1012.

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tralegal social contracts"[227] governing entitlement. Social relations would thus limit the "institutional supply"[228] available. Their proposal echoes and cites[229] the influential[230] 19th century German Historical School, which suggested that the law should be distilled from customs and legal concepts found in the population (the *Volksgeist*, i.e. spirit of the people).[231] Such normative views are beyond the scope of this essay. De Soto and Fitzpatrick's observations do however serve to anticipate future or explain past conflicts, and to identify historical path dependence.[232]

In the following part, I will use this background to explain the occurrence of social conflicts in the English and their absence in the Chinese case. I demonstrate that the enclosures conflicted with a social contract that had long been established in English villages. The conflicts' outcome approximates ideal type (1): Formal law holds primacy and the old social norms are abandoned. The whole transition was accompanied by great grievances for those relying on the pre-reform social order. In the Chinese case, I will show how for the most part formal legal change accommodated existing social norms. Where there were conflicts, their outcome resembled ideal type (2), with formal law remaining widely ineffectual.

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[227] DE SOTO, *supra* note 3, at 181; Fitzpatrick, *supra* note 3, at 1045–47.

[228] Fitzpatrick, *supra* note 3, at 1046–47. For a definition of institutional supply, see LIBECAP, *supra* note 7, at 7 ("The menu of possible institutional solutions to varying economic problems."). *See also* DE SOTO, supra note 3, at 181–82; Stoddard, *supra note* 129, at 983.

[229] *See* DE SOTO, *supra* note 3, at 189 (lauding Swiss reformer Eugen Huber's "old German saying: Das Gesetz muss aus dem Gedanken des Volkes gesprochen sein"—the law must be spoken from the thought of the people).

[230] *See, e.g.*, Philip Selznick, *Sociology and Natural Law (Paper 61)*, NATURAL LAW FORUM, 84, 84–5 (1961) (commenting on its influence on sociology of law); R. C. VAN CAENEGEM, AN HISTORICAL INTRODUCTION TO PRIVATE LAW 158 (1988) ("The influence (of the German legal doctrine and philosophy of the time) was felt in all countries and all areas of law.").

[231] *See generally* LUC J. WINTGENS, LEGISPRUDENCE: PRACTICAL REASON IN LEGISLATION 179 (2012). On the religious roots of the concept of a Volksgeist, see Hans-Peter Haferkamp, *Die sogenannte Begriffsjurisprudenz im 19. Jahrhundert—"reines" Recht?*, *in* REINHEIT DES RECHTS: KATEGORISCHES PRINZIP ODER REGULATIVE IDEE? 79, 88–89 (Otto Depenheuer ed., 2010). On the philosophical tradition of this approach, see KARL LARENZ, METHODENLEHRE DER RECHTSWISSENSCHAFT 19–22 (1975). *See further* VAN CAENEGEM, *supra* note 231, at 158–59.

[232] On the question of path dependence in property rights change, see LIBECAP, *supra* note 7, at 7.

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A. China, Reform-Society Interaction

The Chinese land reform concerned two relations in the village: The first was the relation between individual villagers and the village land, marked by a social norm of egalitarianism. The second was the relation between the individual and the village as a whole, marked by a sense of community.

1. Egalitarianism (Villager-Land Relation)

Associated with Confucian thought,[233] intra-village egalitarianism as a social norm (every member of the village community is to have equal income from the village land) traditionally played an important role in rural Chinese society,[234] mirrored in a widely egalitarian pre-reform social order.[235] Egalitarianism continued to play an important role in village life post-reform, apparently hardly affected by the property rights change.[236]

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[233] Albeit its foundation is fragile, the association of egalitarianism with Confucianism appears widely shared, see, e.g., RICHARD MADSEN, MORALITY AND POWER IN A CHINESE VILLAGE 59 (1984). We find traces of egalitarianism in the Confucian analects, see, *e.g.*, THE ANALECTS OF CONFUCIUS, *available at* http://www.indiana.edu/~p374/Analects_of_Confucius_(Eno–2015).pdf. ("The Ji family was wealthier than the Duke of Zhou. Qiu assisted them in the collection of taxes and so enlarged their riches further. The Master said, 'He is no follower of mine! Young men, you have my permission to sound the drums and drive him away.'") For a nuanced account on the relation of Confucianism and egalitarianism, see RUIPING FAN, RECONSTRUCTIONIST CONFUCIANISM: RETHINKING MORALITY AFTER THE WEST 28–29 (2010).

[234] The egalitarianism here described concerns only the difference in wealth in a single village community, not between villages or regions. For an account of the importance of this distinction, see Martin K. Whyte, *China's Post-Socialist Inequality*, CURRENT HISTORY, 229–30 (2012) (observing that pre-reform, only in the confines of individual villages was the social order egalitarian). On the traditional importance of egalitarianism in Chinese rural society, see Qiao, *supra* note 22, at 132.

[235] *See* Koen Rutten, *Social Welfare in China: The Role of Equity in the Transition from Egalitarianism to Capitalism* (Asia Research Centre, Copenhagen Business School, Discussion Paper No.32 2010), *available at* http://openarchive.cbs.dk/bitstream/handle/10398/8018/Koen.pdf?sequence=1. *But see* Martin K. Whyte, *The Paradoxes of Rural-Urban Inequality in Contemporary China*, *in* ONE COUNTRY, TWO SOCIETIES: RURAL-URBAN INEQUALITY IN CONTEMPORARY CHINA 5–12 (Martin K. Whyte ed., 2010) (arguing that the widely shared perception of pre-reform society as egalitarian is simplistic).

[236] *See, e.g.*, Nee & Sijin, *supra* note 15, at 22 (observing six years after the broad adoption of the HRS that the collectives' redistributive function still had a strong moral base in the Chinese villages); Rutten, supra note 236, at 24 (con-

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Prior to the introduction of the HRS, the state had already attempted a property rights change challenging egalitarianism: the work point system. This had sought to prevent the tragedy of collective action in production teams, re-individualizing incentives:[237] A peasant's effort would be translated into work points, which enlarged his share of the residue.[238] While sparse monitoring weakened the system's legitimacy,[239] its demise was the conflict with the egalitarian social contract in the villages.[240] Work points were eventually widely assigned along egalitarian lines, rendering the system dead letter law.[241]

While the HRS was an individualization of property rights, it did not initially depart from the social norm of egalitarianism. The HRS guaranteed all village households access to land,[242] and the plots were assigned along egalitarian lines.[243] In the first

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tending that "renewed concern for the provision of a ubiquitous standard of living . . . may well herald the beginning of a more egalitarian society"); Qiao, *supra* note 22, at 132–33 (studying empirically in Hubei province the egalitarian distribution of village commons in the post-reform absence of authority or written rules); *See further* James Kai-sing Kung, *Choice of Land Tenure in China: The Case of a County with Quasi-Private Property Rights*, 50 ECON. DEV. AND CULTURAL CHANGE 793, 793 (2002).

[237] *See* Lin, *supra* note 63, at 411.

[238] *See id.* at 411–12.

[239] For increased effort to translate into accumulation of work points, the effort needed to be monitored. While such monitoring might be effective in collective enterprises, the nature of agricultural production, its "sequential nature and spatial dimension," makes effort difficult to monitor. Lin, *supra* note 171, at 199. Effective supervision was thus very costly, hence the optimum degree of supervision low. *See* Lin, *supra* note 63, at 412 (The poor monitoring made it almost impossible to fairly distribute work points according to effort).

[240] *See* Nee & Sijin, *supra* note 15, at 18 (describing how disputes amongst peasants were especially prone to arise where one had received more work points than the others). *See also* Kung, *supra* note 237, at 793. For a very similar account of how a work point system in Communist Poland failed due to peasant resistance on egalitarian grounds, see Chris Hahn, *Die Bauern und das Land. Eigentumsrechte in sozialistischen und postsozialistischen Staatssystemen im Vergleich*, *in* EIGENTUM IM INTERNATIONALEN VERGLEICH (18–20. JAHRHUNDERT) 161, 168 (Hannes Siegrist & David Sugarman eds., 1999).

[241] *See* Nee & Sijin, *supra* note 15, at 8.

[242] *See, e.g.*, HO, *supra* note 14, at 11; James Kai-sing Kung & Shouying Liu, *Farmers' Preferences Regarding Ownership and Land Tenure in Post-Mao China: Unexpected Evidence from Eight Counties*, 38 CHINA J. 33, 33–34 (1997). In today's property rights order this is safeguarded in Article 27 of the RLCL, which stipulates that village collective shall have reserve land to accommodate new households.

[243] *See* Kung, *supra* note 237, at 793; Clarke, *supra* note 70, at 183; Putterman, *supra* noet 17, at 1053.

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decade of the HRS, the collectives' authority to redistribute land following changes in household size ensured its egalitarian distribution.[244] Hence, the HRS at first did not contradict the established social norms, though it did add to income disparities in the villages.[245] For a long time, studies found peasants supportive of such readjustment.[246] Moved by warnings that readjustments would cause inefficient land use,[247] resource degradation[248] and threats to family planning policy,[249] in the second decade of the HRS the central government increasingly pursued a policy of minimal readjustment.[250] This policy conflicted with the social norm of egalitarianism, and again, initially the social norm prevailed.[251] Only with article 27 of the RLCL clearly forbidding the

[244] *See* Lei Chen, *Legal and Institutional Analysis of Land Expropriation in China*, *in* RESOLVING LAND DISPUTES IN EAST ASIA 59, 65 (Hualing Fu & John Gillespie eds., 2014).

[245] *See* Gelb et al., *supra* note 69, at 119.

[246] *See, e.g.*, Kung, *supra* note 237, at 793–95; Kung & Liu, *supra* note 243, at 34; HO, *supra* note 14, at 11 (citing "government and academic studies").

[247] *See generally* Michael D. Whinston & Ilya R. Segal, *Property Rights* 27–28 (Stanford Law and Economics Olin Working Paper No. 394, 2010), *available at* http://ssrn.com/abstract=1577382 (summarizing the 'hold-up' literature that predict losses in efficiency where those investing fear others may prevent them from extracting the gains of their investment in the future). For a treatment of this problem along the lines of classical law and economics, see GEORGE, *supra* note 203, at 220. Specifically for the Chinese case, see, e.g., Jeff Bennett & Andreas Kontoleon, *Property Rights and Land Degradation in China* 5, *available at* https://crawford.anu.edu.au/pdf/staff/jeff_bennett/china_land_use/property_rights_and_land_degradation_in_china.pdf; Travers, *supra* note 70, at 251–52; Putterman, *supra* note 17, at 1053. For the similar problems caused by land takings in current China, see Benjamin James, *Expanding the Gap: How the Rural Property System Exacerbates China's Urban-Rural Gap*, 20 COLUM. J. ASIAN L., 476, 480 (2007).

[248] Specifically with regard to China, see, e.g., Bennett & Kontoleon, *supra* note 248, at 2; Korff, *supra* note 15, at 409. *But see* HO, *supra* note 14, at 13 (concluding from recent surveys that the perception that tenure insecurity would lead to resource degradation in China proved to be "wholly unfounded").

[249] *See generally* James Kai-sing Kung, *Do Secure Land Use Rights Reduce Fertility? The Case of Meitan County in China*, 82 LAND ECON. 36, 53 (2006).

[250] *See* Ray Yep, *Containing Land Grabs: A Misguided Response to Rural Conflicts Over Land*, 22 J. CONTEMP. CHINA, 273, 281 (2013); Kung & Liu, supra note 243, at 34.

[251] *See* HO, *supra* note 14, at 10 (observing that cooperatives in some parts of China experienced strong pressure by the village community to keep readjusting land).

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practice in 2002 it has faded, seemingly correlating with a weakened popular support for readjustment.[252]

2. Sense of Community

The pre-reform property rights system entailed cooperation in production teams modeled after natural villages. Should we then expect a social norm of cooperative work similar to that of pre-enclosure England, which then conflicted with the individualist HRS? The existence of such a norm is doubtful. Comparatively short, the PRC history of rural property rights was highly fluctuating, with several reforms fundamentally altering the rural agricultural system. The decades of collective agriculture saw several local initiatives to introduce a household-based agricultural system, which only faltered under the political pressure of higher levels of government.[253] The spontaneity with which the HRS sprung up simultaneously in different locations around 1980 also implies that a household-based system was in concord with village social contracts.

While it did not conflict with a cooperative culture, the HRS might have challenged a more general sense of community, of common roots and common purpose of the villagers. Economically, in production teams villagers had been companions in fate, sharing the residue of the land or together suffering the lack thereof. This mutual dependence shaped other aspects of village life. The People's Commune was both a social and economic unit, and its headquarter the very "center of village activity."[254] Village life in general was based on familiarity.[255] The HRS afforded individual households greater economic and social

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[252] *See* Pauline Grosjean & Andreas Kontoleon, *How Sustainable are Sustainable Development Programs? The Case of the Sloping Land Conversion Program in China* (University of Cambridge: Environmental Economy and Policy Research, Discussion Paper No.26, 2007); *see further* BENNETT & KONTOLEON, *supra* note 248, at 7; James, supra note 248, at 476.

[253] *See e.g.,* LING ZHU, RURAL REFORM AND PEASANT INCOME IN CHINA, 11–13 (1991) ("During the twenty years of communal farming, the responsibility system came into being four times, bur was banned first three times in order to curb individualism"); *see similarly* FEWSMITH, *supra* note 92, at 25–27.

[254] *See e.g.,* Nee & Sijin, *supra* note 15, at 18 (quoting a village cadre pointing to the ruined headquarters stating that it "used to be a place where people came every day. At night they would gather here, drinking tea and chatting."). *See further* Shue, *supra* note 14, at 259.

[255] *See* Qiao, *supra* note 22, at 126–27.

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autonomy,[256] but also forced them to greater self-reliance as its early years were marked by a steep decline in village welfare systems and collective resource management.[257] Nevertheless, village life post-reform was likely short of a Hobbesian:[258] While collective social insurance had faded, the demies of the commune resulted in the re-emergence of customs and a partial strengthening of community relations.[259] Only in the long term the independence gained through the HRS, together with the general changes of reform and opening up, resulted in eroding village ties.[260]

B. England, Reform-Society Interaction

Pre-enclosure, social norms arguably shaped English village life more than formal law did. The open fields system had been part of English (and generally Northern European) agriculture since the 11th century.[261] It covered all village land and forced the villagers to cooperate, thus shaping social relations amongst all villagers. The open fields were rooted in tradition, stemming from a time that little distinguished between social norms, customs and formal law.[262] Where it existed, formal law was embedded in and shaped by social norms, and to the villagers, the line between law and social norms was often blurred.[263] The enclosures brought about legal change that strongly disputed the established system, a dispute only partially intended by the proponents of enclosure. For the most part the formal law prevailed, and

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[256] *See e.g.*, Nee & Sijin, *supra* note 15, at 21 (observing how this autonomy is "evident in the more diverse mix of social and economic institutions that now constitutes the social order of the villages").

[257] *See e.g.*, *id.* at 19 (citing the breakdown of pest-control programs); Qiao, *supra* note 22, at 128 (observing a decline in the management of common resources); Travers, *supra* note 70, at 252.

[258] *But see* Nee & Sijin, *supra* note 15, at 22 (describing villages to be "reverting to a Hobbesian community of individualistic households").

[259] *See* LI, *supra* note 172, at 6.

[260] *See* Qiao, *supra* note 22, at 127 (elaborating on the results of increasing commercialization and migration).

[261] *See e.g.*, Sharman, *supra* note 24, at 46–47; Clark & Clark, *supra* note 23, at 73.

[262] *See* Sharman, *supra* note 24, at 47.

[263] *See* Jeanette M. Neeson, *English Enclosures and British Peasants: Current Debates about Rural Social Structure in Britain c.1750–1870*, JAHRBUCH FÜR WIRTSCHAFTSGESCHICHTE / ECONOMIC HISTORY YEARBOOK 24, 31 (2000) (pointing to the erratic use of the word 'right' by those holding entitlement to the common).

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conflicting social contracts were adjusted or broken. In addition to the villager-land and villager-community relations, the enclosures also affected special relations between villagers: those of employment, and those of family. How enclosures impacted these relations can explain the social conflict that accompanied enclosure.

1. Access to Land (Villager-Land Relation)

The pre-enclosure property rights regime was remarkable in that usually all villagers had access to land. Village land was subject to a variety of different regimes (individual property, commons, open access), and very small sticks in the property rights bundle (e.g., the right to glean after harvest, or the right to have a single cow graze on the commons) were accessible individually. Therefore, the economic threshold to having property rights was remarkably low in some parts (access to common rights, access to a single strip on the open fields), and nonexistent in others (access to gleaning, and to wastes). For the vulnerable part of the village population, this land regime constituted an equivalent to social insurance.[264] It was "a source of several incomes, . . . a resource that kept them, to some degree, out of the market for food and other essentials."[265] For all villagers, access to land provided for upward mobility, as villagers might slowly accumulate property rights.[266] It had done so for centuries, and villagers strongly relied on it. Formulated as a social norm, the village land was to profit all villagers—to a small degree at least.

The effects of enclosure on this social norm are uneven and disputed.[267] What follows here again is an ideal-typical account. The enclosures were a "rupture of the traditional integument

[264] *See* Humphries, *supra* note 39, at 38–39.

[265] *See* Neeson, *supra* note 264, at 31.

[266] *See* HAMMOND & HAMMOND, *supra* note 25, at 1760–1832 ("The most important social fact about this system is that it provided opportunities for the humblest and poorest labourer to rise in the village."); *see similarly* Neeson, *supra* note 264, at 31.

[267] For an overview on the 20th century dispute on the impact of enclosure on small peasant and landless laborer, see K. D. M. SNELL, ANNALS OF THE LABOURING POOR: SOCIAL CHANGE AND AGRARIAN ENGLAND, 1660–1900 138–47 (1987).

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of . . . customs and right"[268] that supported all villagers' access to land. Their procedure was designed in a way that eroded small sticks in the property rights bundle. The economic change following the enclosures further marginalized those entitlements that had survived.[269] To many villagers, land became "commodity that they could neither use, rent nor buy."[270] And so enclosures broke the pre-reform social contract, disrupting the significant role village land had played in the lives of a great part of the population.

How did the small peasants lose their relation to the land? Open fields were divided in narrow strips, and peasants could accumulate several of them.[271] While these plots were small individually, their shape allowed for reasonably efficient farming. As they were unfenced, there were no costs of demarcation. Since those holding strips of land also held common grazing rights, they were able to combine farming with cattle holding. With enclosure, small landowners were to receive a consolidated plot equaling in value their previously held strips. For two reasons, this was likely to end small farming.[272] Firstly, enclosures demanded fencing, and fencing was costly.[273] It is a lesson in geometry that the relative costs of fencing rise where the size of a plot decreases.[274] The costs of fencing came as a single, large investment. Small peasants were less likely to have the free capital this

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[268] *See* Sharman, *supra* note 24, at 66.

[269] *See* WOOD, *supra* note 85, at 83–84.

[270] *See* Neeson, *supra* note 264, at 31.

[271] *See e.g.*, Thompson, *supra* note 31, at 623; Clark & Clark, *supra* note 23, at 73.

[272] On the statistical effect of enclosures on small farm holding, see Neeson, *supra* note 264, at 30.

[273] Enclosure acts not only permitted but frequently mandated peasants to erect physical barriers (fences, ditches, more often hedges) to enclose their newly allotted land. *See* Sharman, *supra* note 24, at 66. On the costs of fencing, see Tate, *supra* note 202, at 265; see Turner, *supra* note 105, at 38.

[274] Assuming peasants' fields are square (an assumption much more realistic post-enclosure than before), then the size of the land is (length of one side)^2 while the length of the barrier to be erected is (length of one side)*4. Where the field gets larger, the area grows exponentially, whereas the fence only in a *4 ratio. For illustration, we may imagine square plots 1m^2, 16m^2 and 256m^2 in size. The first plot requires a fence of 4m (fence/area ratio of 4/1), the second of 16m (fence/area ratio of 16/16 = 1/1), and the third of 64m (fence/area ratio of 64/256 = 1/4). Thus, for one m^2 of arable land to be physically enclosed, the first farmer pays 4, the second 1 and the third 0,25. Thus the area/fence ratio increases the larger the area, to the benefit of peasants owning large plots of land.

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required.[275] Secondly, small farmers were typically unable to use their new plot as effectively as they had used their previous combination of long strips and common grazing rights.[276] Where enclosure made small farms unviable, farmers were left with no option but "a hasty sale to cover costs,"[277] and to become landless laborers.

How did the landless laborers fare? While those villagers who pre-enclosure did not hold strips on the open fields were considered landless, they did hold property rights: Some may have held common rights, the poor enjoyed the privilege of gleaning, and all utilized the open-access wastes. The legal nature of these entitlements differed, and so did their fate in enclosure. They all were however marginalized, for reasons similar to those that scholars report from developing countries' property reforms today.[278]

Landless villagers might hold common rights, usually rights of pasture. They were unlikely to be tenants of common-rights cottages, but they could rent (often at low cost[279]) or otherwise trade for common rights.[280] Cows required little upkeep, and their produce usually sufficed to pay the rent of the common right, and to pay off initial investments.[281] Cows could contribute substantially and continually to family income,[282] and their by-products

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[275] Large landowners, whose yearly harvest more than sufficed to support their living, were far more likely to have savings readily available. Where these farmers had to resort to credit, such credit likely was available to them. Small landowners however were far more likely to have no savings, as they virtually lived (barely) off their land. Worse, their estates were often mortgaged to up to two thirds of their value, rendering it very difficult to access credit to finance the enclosure. *See generally* Turner, *supra* note 105, at 38.

[276] *See* Humphries, *supra* note 39, at 19–20.

[277] *Id.* at 20.

[278] For the early modern English experience see WOOD, *supra* note 85, at 83–84. For the experience in today's developing countries, see DE SOTO, *supra* note 3, at 175 ("(L)egal procedures to create formal property are not geared to process extralegal proofs of ownership that lack visible chain of title—but this is only evidence available to poor."); see similarly Fitzpatrick, *supra* note 3, at 1013.

[279] *See* Humphries, *supra* note 39, at 23.

[280] *See* Clark & Clark, *supra* note 23, at 1030–32.

[281] *See* Humphries, *supra* note 39, at 28 (observing that since cows were taken care of by women and children who were otherwise seldom employed, they produced little to no opportunity cost).

[282] A cow's weekly produce averaged close to what a female laborer might receive for wage labor, more than half of what a fully employed male could

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added to the family's diet.[283] They served either to supplement the income from wage labor, or to support members of the village who otherwise would have relied on their families.[284] Common rights' disappearance in enclosure often went uncompensated. Some previous benefits were not considered property rights.[285] Others were poorly documented, thus failing to sustain the contested process of enclosure.[286] Again other common rights, in particular the privilege of gleaning, were considered mere custom.[287] These were "simply disregarded by the vast majority of enclosure commissions."[288] Where such privileges extended into enclosed land by the generosity of the new landowners, they either did not survive the economic change brought by enclosures[289] or were otherwise "whittled away over the course of sixteenth and seventeenth centuries."[290] Perhaps more hurtful than the lack of compensation was the disappearance itself: The new regime no longer offered property rights that could be used to substitute family income.

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expect, see *id.* at 24, 29; see Shaw-Taylor, *supra* note 23, at 644; see HAMMOND & HAMMOND, *supra* note 25, at 15 ("a Privilege that enables them to maintain . . . their Families in the Depth of Winter," citing a petition against an Enclosure Act of 1797).

[283] *See e.g.* Humphries, *supra* note 39, at 24–25; *see similarly* Neeson, *supra* note 264, at 22.

[284] It seems to have been rather typical for widows to rely on cow keeping. *See generally* Humphries, *supra* note 39, at 38–39 ("panacea for feminized poverty").

[285] Tenants of common-rights dwellings were not compensated because such rights had been the owner's, not the tenant's. *See* Shaw-Taylor, *supra* note 23, at 658.

[286] *See* WOOD, *supra* note 85, at 83.

[287] On the judiciary's perception of the privilege of gleaning, see Steel v. Houghton, [1788] 126 Eng. Rep. 32 ("No person has, at common law, the right to glean the harvest field."). On the uncertain sources of common rights, *see* HAMMOND & HAMMOND, *supra* note 25, at 8 ("long prescription, or . . . encroachments tacitly sanctioned").

[288] Humphries, *supra* note 39, at 20; for a critical view on the commissioners' approach, see HAMMOND & HAMMOND, *supra* note 25, at 17 ("roughly disentangled by the sheer power of the stronger").

[289] Under the open fields system however, gleaning was not likely to be opposed by the landed peasants because of its similarity to other common rights that reigned over agricultural land after harvest. Enclosure entailed both a tighter control of the owner over his land (manifested in its fencing), and often the conversion of arable land into pasture. The enclosure frequently challenged gleaning; the conversion invariably put an end to it, as it was a worthless privilege to glean on pasture. *See generally* Humphries, *supra* note 39, at 34.

[290] WOOD, *supra* note 85, at 83–84.

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All villagers had access to the wastes, yet the landless villagers likely made most use of them. While the wastes were usually confined to land of little value, they were often the only part of the village open to the landless poor and of significant support to them. Poor families used them for hunting and gathering, or to graze smaller livestock.[291] The wastes were of great importance for all villagers to gather fuel.[292] Enclosures let the wastes disappear. Since property rights to them had been thinly spread over the entire village population, this prior privilege could not be compensated in land. Instead, enclosures usually allocated funds to the poor, often governed by the church.[293] Thus, what had previously been a property rights was transformed to charitable donations, to be applied for by the poor and to be handed out at the discretion of the fund's administrators.[294]

2. Independence (Villager-Villager Relation)

The loss of property rights studied above strongly affected the social relations between individual groups of villagers. The most prominent change in individual social relations was proletarianization, i.e. the increased dependence of landless laborers on landed peasantry.[295] This was a gradual process, affecting rural laborers that before had been semi-proletarian. Proletarianization was an intended result of enclosure.[296] Pre-industrial agriculture

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[291] *See, e.g.*, Humphries, *supra* note 39, at 31–32 ("Almost every living thing in the parish however insignificant could be turned to some good use."); *see similarly* Neeson, *supra* note 264, at 23–24.

[292] *See e.g.* Humphries, *supra* note 39, at 32; Neeson, *supra* note 264, at 22–23.

[293] Such compensation may be a fund to finance coal for the poor, to compensate their lost right to fuel gathering. *See* Humphries, *supra* note 39, at 24.

[294] *See* Humphries, *supra* note 39, at 34 (suggesting that such handouts were undoubtedly conditional on the applicants' "characters" and "behavior," and for that reason much welcomed by the landed peasants who sought to both pacify and control the poor).

[295] *See* Humphries, *supra* note 39, at 41; *see* GRIFFIN, *supra* note 94, at 65. The thesis that enclosure caused proletarianization is rooted in the thoughts of Karl Marx. KARL MARX, CAPITAL: A CRITIQUE OF POLITICAL ECONOMY. VOLUME I 511–12 (1887). It was taken up and expanded by the Hammonds. HAMMOND & HAMMOND, *supra* note 25, at 10. It is perhaps one of the most disputed aspects of enclosure.

[296] Landed peasants had come to oppose the commons, as these were considered to render laborers indolent, or simply to occupy them with other tasks than wage labor. *See* HAMMOND & HAMMOND, *supra* note 25, at 13–4; Humphries, *supra* note 39, at 29; Neeson, *supra* note 264, at 31.

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relied on an elastic labor supply.[297] Common rights and wastes had before lessened the villagers' need to respond to the beck and call of the landed peasants, or had even pre-occupied their families in times of harvest. The demise of common rights strongly reduced non-wage income, and thereby put an end to villagers' relative economic independence: "post-enclosure wage-dependence meant a new kind of poverty, a new vulnerability experienced and understood as the loss of land or rights."[298] The share of villagers thusly affected was immense.[299]

A second relation affected was that of family. Pre-enclosure, in semi-proletarian families, the wife/mother and children had been the primary exploiters of common rights.[300] This led to a social norm according to which all family members were obliged and entitled to independently contribute to the family income. The disappearance of common rights therefore "necessarily spilled over into . . . intra-family patterns of dependence and support,"[301] with families henceforth almost wholly dependent on the husband/father as wage earner.[302] The way enclosures conflicted with established intra-family relations. How the reform changed these to the disadvantage the wife/mother was mirrored in women's remarkably strong role in resistance to enclosure.[303]

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[297] The un-mechanized haymaking and harvest at the time of enclosures demanded a great labor supply to be available for a short period of the seasonal cycle. *See generally* Humphries, *supra* note 39, at 29, 41.

[298] Neeson, *supra* note 264, at 31.

[299] *See* Humphries, *supra* note 39, at 18 ("In this sense it affected some of the 60 percent of families already in receipt of wages by the end of the seventeenth century."); *See similarly* Neeson, *supra* note 264, at 31. *But see* Shaw-Taylor, *supra* note 23, at 641, 659 (observing that pre-enclosure, a significant part of the rural populace was "thoroughly proletarian already").

[300] *See* Humphries, *supra* note 39, at 38 (citing a variety of historical evidence).

[301] *Id.* at 21, 41.

[302] While women were at times employed in agriculture (especially at harvest time), this was not the rule and their wage was often no more than half of a male wage. *See id.* at 40–42. On the importance of common rights as a "fall-back position" empowering women in rural households, see CARMEN D. DEERE & MAGDALENA LEÓN, EMPOWERING WOMEN: LAND AND PROPERTY RIGHTS IN LATIN AMERICA 27 (2001).

[303] *See* Humphries, *supra* note 39, at 38.

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3. Sense of Community

English villages had evolved a sense of "ancient community,"[304] "a way of life that is now lost"[305]: With its scattered plots on open fields, its commons and wastes, village life required "both a base-level ideal and a daily practice of communal cooperation."[306] People negotiated land use, and then worked together amicably to lay the basis for their collective prosperity.[307] Even at times villagers did not need to cooperate, the small size of their plots and the absence of partitions set them in constant relation to one another.[308] With this "communal system"[309] came a communal spirit, as villagers were "disciplined from early youth to submit to the customs of their community."[310] While such spirit "need not be considered warm and cuddly,"[311] it "fostered solidarity," [312] formed an "intense localism," [313] and generally "strengthened bonds between peasants."[314]

Enclosures conflicted with these societal relations, and prevailed over them: "(T)he discipline of sharing . . . was relaxed, and every household became an island unto itself."[315] This was mirrored in the rural landscape: Where previously houses huddled together in a "nucleated village,"[316] they now stood isolated "like raven's nests"[317] on fields divided by hedges.[318] The change was disruptive: "The agricultural community . . . was taken to piec-

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[304] HAMMOND & HAMMOND, *supra* note 25, at 17.

[305] *See* Thirsk, *supra* note 75, at 255; *see similarly* NEESON, *supra* note 76, at 5.

[306] Kaeuper, *supra* note 87, at 87.

[307] *See* Thirsk, *supra* note 75, at 255; ALLEN, *supra* note 29, at 66.

[308] *See* Thirsk, *supra* note 75, at 255 ("They toiled side by side in the fields and they walked together from field to village, from farm to heath."); *see similarly* NEESON, *supra* note 76, at 2.

[309] WOOD, *supra* note 85, at 83–84.

[310] Thirsk, *supra* note 75, at 255.

[311] Kaeuper, *supra* note 87, at 87; *see similarly* HAMMOND & HAMMOND, *supra* note 25, at 9–10.

[312] ALLEN, *supra* note 29, at 66.

[313] Kaeuper, *supra* note 87, at 87.

[314] ALLEN, *supra* note 29, at 66.

[315] Thirsk, *supra* note 75, at 255.

[316] ALLEN, *supra* note 29, at 42.

[317] HAMMOND & HAMMOND, *supra* note 25, at 10.

[318] *See* Sharman, *supra* note 24, at 66; NEESON, *supra* note 76, at 5; KAIN et al., *supra* note 40, at 1 (naming enclosure "one of the most important formative processes in the evolution of the landscape").

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es,"[319] marking a "great revolution in men's lives, greater than all economic changes following enclosure."[320] Historians observe a "gigantic disturbance,"[321] a "dislocation in the way of life,"[322] a sudden "friction in agrarian society."[323] The divisive effect was reinforced by (at times violent) resistance to enclosure, with areas prone to riots becoming known as "dark corners of the land."[324]

C. Comparative View

The study above yields two results. First, the Chinese introduction of the HRS did not strongly dispute existing social norms, while the English enclosures did. Second, where in China, (pre-reform and post-reform) property rights changes challenged the social norms, the social norms prevailed: The work point system proved ineffective, and existing social norms long frustrated efforts to abolish the reassignment of land following demographic changes. In England, the formal law prevailed, to disruptive effects: For small peasants and landless laborers, "the meaning of land . . . changed"[325]: It was no longer a multi-faceted source of income, but a place they worked on for others. Relations between villagers also transformed, rendering some of them much more dependent on others than they could have been before. Finally, the entire sense of community of villages was disrupted, weakening all bonds among villagers. All these impacts proved conductive to social conflict: As the land no longer offered a means of income to everyone, the poorest of the village were uprooted, and left in a "new vulnerability"[326] not known before. This was accompanied by a visible strengthening of their wealthier neighbors, to whose beck and call they were now increasingly subjected. All this was accompanied by a loss of trust in the general community, and a loss of bonds that might otherwise have favored a harmonious solution of differences.

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[319] HAMMOND & HAMMOND, *supra* note 25, at 11.

[320] Thirsk, *supra* note 75, at 255 (considering the loss of community the "strongest argument for retaining common fields . . . that no contemporary ever mentioned").

[321] HAMMOND & HAMMOND, *supra* note 25, at 16.

[322] GRIFFIN, *supra* note 94, at 65.

[323] Manning, *supra* note 79, at 120.

[324] GRIFFIN, *supra* note 94, at 65, 68.

[325] Neeson, *supra* note 264, at 31.

[326] *Id.*

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These findings suggest that societies are not easily subjected to social engineering through property rights reform.[327] They also imply that where the reform manages to transform society, the price of social disruption might be high, and it may well be the most vulnerable parts of society paying it.[328] How do the observations on property rights *change* relate to the findings on the reforms' *process* explained above? It seems that in England, conflict was caused both by the process of enclosure, and by the change it entailed: While the parliamentary enclosure has been far more disruptive, there are reports of conflict after enclosure by agreement.[329] As the theory of institutional reform suggests,[330] the correlations found here imply a causal link between relational process and harmonious change: Chinese reform and the English enclosure by agreement created property arrangements that harmonized with existing social relations precisely because social relations had guided them.

VII. CONCLUSION

This article compared Chinese and English land reforms to illustrate how a focus on social relations can inform our understanding of property rights change. This has two implications. First, my findings support those who seek to draw a broader picture of property rights change. They encourage us to depart from the unitary development proposed by Demsetz in favor of recognizing multiple causes for property rights choice (an "eclecticism of land regimes"[331]), and multiple ways in which property reforms affect society. Second, this article adds to our understanding of the conflicts associated with property rights reform. It is

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[327] For a similar conclusion after comparing Chinese reforms and those of post-communist Eastern Europe, see Ho, *supra* note 102, at 2.

[328] For similar observations on property rights reforms in developing countries, see DE SOTO, *supra* note 3, at 175; Fitzpatrick, *supra* note 3, at 1013.

[329] *See* Thompson, *supra* note 31, at 621 ("While since the fifteenth century there is a record of hostility towards enclosure, it was the legislatures' involvement in enclosure after 1700 that sparked strong resistance.").

[330] The bottom-up nature of relational property rights change is less inclined to "institutional mono-cropping." Such mono-cropping will likely result in institutions that poorly fit the individual circumstances of the lives they are applied to. *See generally* Ostrom, *supra* note 100, at 28. Ostrom's empirical research further suggests that institutions "developed with considerable input of the resource users themselves" tend to be more effective and stable than those "determined by external authorities." *Id.* at 16.

[331] Ellickson, *supra* note 3, at 1387–88.

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true, as Upham puts it, that "(g)rowth is change, and change means that existing . . . social structures must make way for new ones." [332] But does this necessarily mean "wrenching social change?"[333] I found that property reforms, even where they appear similar from a legal point of view, and where they contribute similarly to economic development, may or may not disrupt social relations. I have identified patterns that render property rights change more harmonious, and others that are breed disruption. This seems to suggest that growth, change and reform need not necessarily entail social conflict. Both implications lead to a single conclusion: Those who explain the outcome of past property reform, those who anticipate the outcome of future reform, and those who design such reforms, would do well not to ignore the social relations aspect to property rights change.

[332] Frank K. Upham, *Property Rights, Commodification, and Land Disputes*, *in* RESOLVING LAND DISPUTES IN EAST ASIA 37, 39 (Hualing Fu & John Gillespie ed., 2014).

[333] *Id.*

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Reimagining Digital Copyright Through the Power of Imitation: Lessons from Confucius and Plato

Giancarlo FROSIO[*]

ABSTRACT

For millennia, Western and Eastern culture shared a common creative paradigm. From Confucian China, across the Hindu Kush with the Indian Mahābhārata, the Bible, the Koran and the Homeric epics, to Platonic mimēsis and Shakespeare's "borrowed feathers," our culture was created under a fully open regime of access to pre-existing expressions and re-use. Creativity used to be propelled by the power of imitation. However, modern policies have largely forgotten the cumulative and collaborative nature of creativity. Actually, the last three decades have witnessed an unprecedented expansion of intellectual property rights in sharp contrast with the open and participatory social norms governing creativity in the networked environment. Against this background, this paper discusses the reaction to traditional copyright policy and the emergence of a social movement re-imagining copyright according to a common tradition focusing on re-use, collaboration, access and cumulative creativity. This reaction builds upon copyright's growing irrelevance in the public mind, especially among younger generations, because of the emergence of new economics of digital content distribution. Along the way, the rise of the users, and the demise of traditional gatekeepers, forced a reconsideration of copyright's rationale and incentives. Scholarly proposals and market alternatives to traditional copyright have attempted to reconcile pre-modern, modern and post-modern creative paradigms. Building upon this body of research, proposals and practice, this Article will finally try to chart a roadmap for reform that reconnects Eastern and Western creative experience in light of a common past, looking for a shared future.

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[*] Giancarlo FROSIO, Senior Lecturer and Researcher, Centre for International Intellectual Property Studies (CEIPI), University of Strasbourg; Non-Resident Fellow, Stanford Law School, Center for Internet and Society. The author can be reached at gcfrosio@ceipi.edu. Please also note that portions of this essay have already been published in Giancarlo F. Frosio, *Resisting the Resistance: Re-sisting Copyright and Promoting Alternatives*, 23 RICH. J. L. TECH. 4 (2017).

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I. INTRODUCTION

Confucius said: "I transmit rather than create; I believe in and love the ancients."[1]Plato—and later Aristotle—made imitation the general principle of art.[2]Confucius ideas of creativity resemble closely that of Plato and pre-modern Western tradition. Art was *mimēsis* of reality, Plato said. In Plato's view, poetry, music, dance—and art generally—imitated reality. In his *Poetics*, Aristotle added that imitation is the distinctive character of humanity: "indeed we differ from other animals in being most given to *mimēsis* and in making our first steps in learning through it—and pleasure in instances of *mimēsis* is equally general."[3] Li Mengyan, late Ming scholar, followed in Confucius' footsteps and somehow echoed Aristotle's arguments on the natural origins of imitation. In praising imitation and explaining the need to address the past, Mengyan contended that "the rules used by the ancients were not invented by them but really created by Nature . . . [so that] when we imitate the ancients, we are not imitating them but really imitating the natural law of things." [4] The focus on transmission, tradition and past has been a companion to Eastern and Western literature equally for a very long time. In Wu Li's opinion, "to paint without taking the Sung and Yuan masters as one's basis is like playing chess on an empty chess-board, without pieces."[5] *Nullumst iam dictum quod non sit dic-*

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[1] *See* Carla Hesse, *The Rise of Intellectual Property, 700 B.C.-A.D. 2000: An Idea in the Balance*, 131 DAEDALUS 26, 26 (2002) (reporting a saying of Confucius which was included in the Lun-Yii, or Anaclects, compiled in China in the fifth-century B.C.).

[2] *See, e.g.*, PLATO, CRATYLUS 423cd, *in* XII PLATO IN TWELVE VOLUMES (Harold N. Fowler trans., Harv. U. Press 1921); PLATO, REPUBLIC 393c, 399a–c, 401a, *in* V-VI PLATO IN TWELVE VOLUMES (Paul Shorey trans., Harv. U. Press 1969); PLATO, LAWS 655d, 668a-c, 795e, *in* X-XI PLATO IN TWELVE VOLUMES (R G. Bury trans., Harv. U. Press 1967–1968); ARISTOTLE, POETICS 1448b, *in* XXIII Aristotle in 23 Volumes (W. H. Fyfe trans., Harv. U. Press 1932) [hereinafter ARISTOTLE, POETICS]; ARISTOTLE, RHETORIC 1371–1371b, 1376a, 1398b, *in* XXII ARISTOTLE IN 23 VOLUMES (J. H. Freese trans., Harv. U. Press1932); *see also, e.g.*, WILLEM J. VERDENIUS, MIMESIS: PLATO'S DOCTRINE OF ARTISTIC IMITATION AND ITS MEANING TO US (Brill Archive 1972).

[3] *See* ARISTOTLE, Poetics, *supra* note 2, at 1448b.

[4] *See* WILLIAM P. ALFORD, TO STEAL A BOOK IS AN ELEGANT OFFENSE: INTELLECTUAL PROPERTY LAW IN CHINESE CIVILIZATION 27 (Stanford U. Press 1995).

[5] *Id.*, at 28.

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tum prius, Terence first noted.[6] In the *Prologue* to *The Canterbury Tales* and other passages, Chaucer presents himself as a mere compiler or translator.[7] To Chaucer, the act of writing was gleaning the harvest of poetry reaped by others: "For wel I wot that folk han here-beforn / Of Makyng ropen [*reaped the harvest of poetry*], and lad away the corn; / and I come after, glenynge here and there / And am ful glad if I may fynde an ere / Of any goodly word that they han left."[8]

At the time of the Renaissance workshop, Duke Cosimo De' Medici is reported to have said that in case of copies that deceive against the original "the copy should be preferred to the original because it contained both skills, that of the originator and that of the copier."[9] Shen Zhou reacted to those asking to put a stop to the forging of its work by saying: "if my poems and paintings, which are only small efforts to me, should prove to be of some aid to the forgers, what is there for me to grudge about?"[10] From Lucian to Confucius, later Chaucer and many others, there was a well-marked perception that creativity was forged by deep cumulative mechanics and imitation was its ally, rather than its enemy.

For millennia, Western and Eastern culture shared a common creative paradigm. From Confucian China, across the Hindu Kush with the Indian *Mahābhārata*, the *Bible*, the *Koran* and the Homeric epics, to African *xhosa imbongi* and European troubadours, our culture was created under a fully open regime of access to pre-existing expressions and re-use. From Platonic *mimēsis* to Shakespeare's "borrowed feathers," culture was

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[6] PUBLIUS TERENTIUS AFER, *Eunuchus ln. 41 (161 B.C. circa), in* I TERENCE: THE LADY OF ANDROS, THE SELF-TORMENTOR. THE EUNUCH 238 (John Sargeaunt trans.. W. Heinemann 1918) ("In fact nothing is said that has not been said before").

[7] *See* ANDREW BENNETT, THE AUTHOR 42 (Routledge 2005); *see also* SEBASTIAN COXON, THE PRESENTATION OF AUTHORSHIP IN MEDIEVAL GERMAN NARRATIVE LITERATURE 1220-1290 7 (Clarendon Press 2001) (mentioning that many well-known German authors of the mid-twelfth and thirteenth century often professed their works to be translations of French and Latin source texts).

[8] *See* Geoffrey Chaucer, *The Legend of Good Women,* Prologue, G version 61-5, *as cited in* JOHN A. BURROW, Medieval Writers and Their Works: Middle English Literature and its Background, 1100-1500 34 (Oxford U. Press 1982).

[9] GIULIO MANCINI, CONSIDERAZIONI SULLA PITTURA 135 (Accademia Nazionale dei Lincei 1956) (1619).

[10] Wen Fong, *Problem of Forgeries in Chinese Paintings,* 25ARTIBUS ASIAE 95, 100 (1962).

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produced under a paradigm in which imitation—even plagiarism—and social authorship formed constitutive elements of the creative moment.[11] Before Romanticism ignited a process of complete commodification of creative artifacts in Western society, market exchange models ran parallel to gift exchange. Indeed, for many centuries, creativity has been repeatedly construed as a gift according to the belief in *scientia donum dei est, unde vendi non potest*.[12] Confucian ideals endorsed a matching vision as proved by the Chinese aphorism "genuine scholars let the later world discover their work rather than promulgate and profit from it themselves."[13] Confucianism finds here an easy parallel with Platonism and its disrespect for Sophists, taking fees for their teachings.

Yet somehow the cumulative, freewheeling nature of creativity seems to find little recognition in modern copyright policies, which build upon a post-Romantic individualistic view emphasizing absolute originality rather than imitation. As Willian Alford explained in *To Steal a Book is an Elegant Offence: Intellectual Property Law in Chinese Civilization*, the same cultural transformation brought about by the Enlightenment and Romantic individualistic experience has not occurred in China nor anywhere else in the non-Western world.[14] However, as too often forgotten, North, South, East, and West have long shared a cumulative, collaborative, communitarian and open-access creative model. For the majority of human cultural history,

[11] *See* Giancarlo F. Frosio, Rediscovering Cumulative Creativity from the Oral-Formulaic Tradition to Digital Remix: Can I Get a Witness? 13 J. Marshall Rev. Intell. Prop. L. 341, 376-90 (2014).

[12] *See* Giancarlo F. Frosio, User Patronage: The Return of the Gift in the "Crowd Society", 2015 Mich. St. L. Rev. 1983, 2036-39 (2015).

[13] ALFORD, *supra* note 4, at 28.

[14] *Id* (examining the law of intellectual property in China from imperial times to the present and locating in the absence of the Enlightenment and Romantic individualistic experience the reason why such protection for scientific and artistic creations is more rhetoric than reality on the Chinese mainland). Please consider, however, that some Chinese scholars, like Chengsi Zheng and Sanquiang Qu noted in response to Alfred that Chinese copyright protection can be traced back to the Song Dynasty. See 郑成思 (Chengsi Zheng),再论中国古代的版权保护 [*Re-discussion on Copyright Protection in Ancient China*], 中国专利与商标[CHINESE PATENTS AND TRADEMARKS], issue 4 (1996); *see also* WENWEI GUAN, INTELLECTUAL PROPERTY THEORY AND PRACTICE: A CRITICAL EXAMINATION OF CHINA'S TRIPS COMPLIANCE AND BEYOND 46-47 (Springer 2014) (noting that some of protection of publishers' rights against unauthorized reproduction were enacted during the Song Dynasty starting form 1068 A.D.).

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economic incentive occupied a secondary role in motivating authors to create. Creativity was mainly a matter of participation. Nonetheless, under a regime of limited economic incentive for creation and confined commodification of information, humanity produced the greatest portion of its culture and knowledge.

The tensions that have historically characterized the nature and the economics of creativity present a cyclical recurrence that obtains even in the digital domain. After being sidelined in the post-Romantic cultural paradigm, cumulative creativity and gift economy are enjoying increasing emphasis in the networked society. Such a long historical view recontextualizes today's digital creativity, user-generated content, and remix culture within a framework of tensions between communal and individual creative expression. The intensifying conflict between market economies and gift economies calls into question not only the institution of copyright law but the wider economic structure it subserves.

Today, in an era of networked mass collaboration, ubiquitous online fan communities, user-based creativity, and digital memes, the enclosure of knowledge brought about by an ever-expanding copyright paradigm seems anachronistic, and a deliberate defiance of inevitable cultural evolution. Aptly, Madhavi Sunder has noted that from MGM v. Grokster, to new licenses from the Creative Commons for developing nations, to the rise of Internet auteurs of fan fiction, mash-ups, and machinima, to efforts to deliver medicines to the world's poor, to demands for "Geographical Indications" for sarees and other crafts of the developing world, and to the nascent global movement for "Access to Knowledge," traditional economic analysis fails to capture fully the struggles at the heart of local and global intellectual property law conflicts.[15]

Strong copyright protection—spearheaded by copyright's principle of exclusivity and strict control over derivative reuses—has turned creativity into an exclusive rather than inclusive process, as it was traditionally for most of our cultural history. In contrast, inclusivity has become the norm of the

[15] Madhavi Sunder, *IP³*, 59 STAN. L. REV. 257, 258 (2006).

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participative process that seems to characterise creativity in the networked environment. Overbroad copyright protection—insofar as it promotes enclosure, commodification and fragmentation of knowledge—runs counter to newly emphasised interest in the free flow of information and production of knowledge in the digital domain. In this respect, opportunities that digitisation and Internet distribution offer to our society make enclosure and commodification of our information environment even more troublesome.

Today, the greater capacity for the dissemination of knowledge, for cultural creativity and for scientific research carried out by means of the enhanced facilities of computer-mediated telecommunication networks, has greatly raised the marginal social losses that are attributable to the restrictions that those adjustments in the copyright law have placed upon the domain of information search and exploitation.[16]

Today, we are in the midst of a war over the future of our cultural and information policies. The preamble of the Washington Declaration on Intellectual Property and the Public Interest explains the terms of this struggle:

> [t]he last 25 years have seen an unprecedented expansion of the concentrated legal authority exercised by intellectual property rights holders. This expansion has been driven by governments in the developed world and by international organizations that have adopted the maximization of intellectual property control as a fundamental policy tenet. Increasingly, this vision has been exported to the rest of the world. Over the same period, broad coalitions of civil society groups and developing country governments have emerged to promote more balanced approaches to intellectual property protection. These coalitions have supported new initiatives to promote innovation and creativity, taking advantage of the opportunities offered by new technologies. So far,

[16] Paul A. David and Jared Rubin, *Restricting Access to Books on the Internet: Some Unanticipated Effects of U.S. Copyright Legislation*, 5 REV. ECON. RES. COPYRIGHT ISSUES 23, 50 (2008).

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> however, neither the substantial risks of intellectual property maximalism, nor the benefits of more open approaches, are adequately understood by most policy makers or citizens. This must change if the notion of a public interest distinct from the dominant private interest is to be maintained.[17]

In the past few years, a global movement grew under the understanding that focusing our attention on the propulsive value of cumulative reuses is pivotal to any discourse about challenges ahead for knowledge governance and principles that should drive our policies for creativity. This movement resisted copyright over-expansion, "resisted the resistance" to the Digital Revolution,[18] while re-imagining copyright, seeking access to knowledge and promoting the public domain. It lies at the crossroad between academic investigation, civic involvement, and political activity. The Pirate Party may serve as an extreme expression of the sentiment of distaste or disrespect for copyright. In the aftermath of the legal battles targeting p2p platforms, the Pirate Party emerged in Sweden to contest elections on the basis of the abolition or radical reform of intellectual property—copyright, in particular.[19] Meanwhile, Creative Commons, the Free Software Foundation and the Open Source

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[17] The Washington Declaration on Intellectual Property and the Public Interest (Aug. 25-27, 2011), Preamble, *available at* http://infojustice.org/ washington-declaration-html. *See also* Sebastian Haunss, *The Politicisation of Intellectual Property: IP Conflicts and Social Change*, 3 WIPO J. 129, 129-138 (2011).

[18] *See* Eben Moglen, Free and Open Software: Paradigm for a New Intellectual Commons**,** Speech at the Law of the Commons Conference at Seattle University (March 13, 2009) (transcript *available at* http://en.wikisource.org/wiki/Free_and_Open_Software:_Paradigm_for_a_New_Intellectual_Commons) (crafting this notion of "resisting the resistance").

[19] *See* Piratpartiet, *International, The Pirate Party*, *available at* http://www.piratpartiet.se/international/english (last visited Jan. 28, 2018) (proclaiming that "[t]he monopoly for the copyright holder to exploit an aesthetic work commercially should be limited to five years after publication. A five years copyright term for commercial use is more than enough. Non-commercial use should be free from day one"); CHRISTIAN ENGSTRÖM AND RICK FALKVINGE, THE CASE FOR COPYRIGHT REFORM (The Swedish Pirate Party & Greens/EFA EP 2012), *available at* http://www.copyrightreform.eu; *see also* Miaoran Li, *The Pirate Party And The Pirate Bay: How The Pirate Bay Influences Sweden And International Copyright Relations*, 21 PACE INT'L L. REV. 281, 281-307 (2009); Jonas Anderson, *For the Good of the Net: The Pirate Bay as a Strategic Sovereign*, 10 CULTURE MACHINE 64, 64-108 (2009); NERI LUCA, LA BAIA DEI PIRATI: ASSALTO AL COPYRIGHT (Cooper Editore 2009).

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movement,[20] propelled the diffusion of viable market alternatives to traditional copyright management. The "power of open," as Catherine Casserly and Joi Ito have termed Creative Commons, has spread fast with more than four hundred million CC-licensed works available on the Internet.[21] Again, mostly driven by scholarly efforts, an Access to Knowledge (A2K) Movement, an Open Access Publishing Movement, a Public Domain Project and Cultural Environmentalism sought to re-define the hierarchy of priorities embedded in the traditional politics of intellectual property. Meanwhile, several proposals have been trying to re-imagine copyright norms to adapt them to digitization and digital creativity.

II. REIMAGINING COPYRIGHT: NOTIONS AND ECONOMICS

Copyright law has fallen into a profound crisis of legitimacy. Both users and creators have largely withdrawn any support for copyright.[22] Especially with new generations,[23] copyright

[20] *See, e.g.*, Moglen Eben, Freeing the Mind: Free Software and the Death of Proprietary Culture, Remarks at the University of Maine Law School's Fourth Annual Technology and Law Conference: (June 29, 2003) (transcript *available at* http://moglen.law.columbia.edu/publications/maine-speech.html); Moglen Eben, *Anarchism Triumphant: Free Software and the Death of Copyright*, (Buchmann International Conference on Law, Technology and Information Discussion Paper, June 28, 1999), *available at* http://firstmonday.org/ojs/index.php/fm/article/view/684/594.

[21] *See* CATHERINE CASSERLY AND JOI ITO, INTRODUCTION, THE POWER OF OPEN (Creative Commons 2011), *available at* http://thepowerofopen.org; *see also* Niva Elkin-Koren, *Exploring Creative Commons: A Skeptical View of a Worthy Pursuit*, *in* THE FUTURE OF THE PUBLIC DOMAIN: IDENTIFYING THE COMMONS IN INFORMATION LAW 325-45 (Lucie Guibault and P. Bernt Hugenholtz eds., Kluwer Law International 2006).

[22] *See, e.g.*, JESSICA SILBEY, The Eureka Myth: Creators, Innovators, and Everyday Intellectual Property (Stanford University Press 2015) (finding, after collecting interview-based empirical data, that suggesting that creators—and even businesses—need intellectual property and exclusivity overstates, if not misstates, the facts and explaining how this misunderstanding about creativity sustains a flawed copyright system); Jessica Litman, *Real Copyright Reform*, 96 IOWA L. REV. 1, 3-5, 31-32 (2010) (noting that "the deterioration in public support for copyright is the gravest of the dangers facing the copyright law in a digital era [...] [c]opyright stakeholders have let copyright law's legitimacy crumble"); JOHN TEHRANIAN, Infringement Nation: Copyright 2.0 and You xvi-xxi (Oxford University Press 2011); *Copyright and Wrong: Why the Rules on Copyright need to Return to Their Roots*, THE ECONOMIST (Apr. 8, 2010), *available at* http://www.economist.com/displayStory.cfm?story_id=15868004 (last visited Jan. 28, 2018) (arguing that copyright should return to its roots, because as it is now it may cause more harm than good).

[23] *See Future of the Internet*, PEW RESEARCH CENTER'S INTERNET & AMERICAN LIFE PROJECT (Oct. 19, 2017), *available at* http://www.pewinternet.org/topics/future-of-the-internet/; EUROPEAN OBSERVATORY ON INFRINGEMENTS OF INTELLECTUAL PROPERTY RIGHTS, THE EUROPEAN CITIZENS AND INTELLECTUAL

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tends to become irrelevant in the public mind,[24] if not altogether opposed. David Lange noted that the over-expansion of copyright entitlements lies at the backbone of their withering public acceptance:

> Raymond Nimmer has said that copyright cannot survive unless it is accorded widespread acquiescence by the citizenry. I think his insight is acutely perceptive and absolutely correct, for a reason that I also understand him to endorse: Never before has copyright so directly confronted individuals in their private lives. Copyright is omnipresent. But what has to be understood as well is that copyright is also correspondingly over-extended.[25]

The Australian Government Productivity Commission builds upon this point, highlighting its practical implications. In the Commission's view, the "copy(not)right" model does fail its goals for a number of critical reasons:

> Australia's copyright arrangements are weighed too heavily in favour of copyright owners, to the detriment of the long-term interests of both consumers and intermediate users. Unlike other IP rights, copyright makes no attempt to target those works where 'free riding' by users would undermine the incentives to create. Instead, copyright is overly broad; provides the same levels of protection to commercial and non-commercial works; and protects works with very low levels of creative input, works that are no longer being supplied to the market, and works where ownership can no longer be identified.[26]

PROPERTY: PERCEPTION, AWARENESS AND BEHAVIOUR 11-14, 54-59 (2013) (noting that the copyright system suffers from a lack of legitimacy in the eyes of young generations).

[24] *See* Brett Lunceford and Shane Lunceford, *The Irrelevance of Copyright in The Public Mind*, 7 NW. J. TECH. & INTELL. PROP. 33, 33-49 (2008).

[25] David Lange, *Reimagining the Public Domain*, 66 LAW & CONTEMP. PROBS. 475, 471 (2003).

[26] Intellectual Property Arrangements, Productivity Commission Draft Report 16 (Australian Productivity Commission, 2016), *available at* https://assets.documentcloud.org/documents/2819862/Intellectual-Property-Draft.pdf.

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Technology—and the cultural change it brought about—played a significant role in lowering copyright's acceptance. In a message delivered to the G20 leaders, Dimity Medvedev pointed out that "[t]he old principles of intellectual property protection established in a completely different technological context do not work any longer in an emerging environment, and, therefore, new conceptual arrangements are required for international regulation of intellectual activities on the Internet."[27] Francis Gurry noted that

> [d]igital technology and the Internet [. . .] have given a technological advantage to one side of the [copyright] balance, the side of free availability, the consumer [. . .] History shows that it is an impossible task to reverse technological advantage and the change that it produces. *Rather than resist it, we need to accept the inevitability of technological change and to seek an intelligent engagement with it*. There is, in any case, no other choice—either the copyright system adapts to the natural advantage that has evolved or it will perish.[28]

Digitization led to challenge the obsolescence of the traditional copyright monopoly, seeking reform. In 1994, John Perry Barlow radically concluded that: "in the absence of the old containers, almost everything we think we know about intellectual property is wrong".[29] Nicholas Negroponte reinforced Barlow's point by stating that "copyright law is totally out of date [. . .] it is a Gutenberg artifact [. . .] since it is a reactive process, it will have to break down completely before it is corrected."[30] Recently, the Hargreaves report observed that archaic copyright laws might be "obstructing innovation and economic growth."[31] Many

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[27] President of Russia Dmitry Medvedev, Message to the G20 leaders (Nov. 3, 2011) (transcripts *available at* http://eng.krem lin.ru/news/3018).

[28] Francis Gurry, Future Directions in Copyright Law, Speech at the Blue Sky Conference at the Queensland University of Technology (Feb. 25, 2011) (transcripts *available at* http://www.wipo.int/about-wipo/en/dgo/speeches/dg_blueskyconf_11.html).

[29] John Perry Barlow, *Selling Wine Without Bottles: The Economy of Mind on the Global Net*, 2.03 WIRED, THE ECONOMY OF IDEAS (Mar. 1, 1994, 12:00 PM), https://www.wired.com/1994/03/economy-ideas/ (last visited Jan. 28, 2018).

[30] NICHOLAS NEGROPONTE, BEING DIGITAL 58 (Alfred A. Knopf 1995).

[31] *See* Ian Hargreaves, *Digital Opportunity, A Review of Intellectual Prop-*

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highlighted the necessity of re-shaping present copyright[32] or abolishing it altogether.[33] In particular, a growing copyright "abolitionism" emerged online in response to a tendency to criminalise the younger generation and new models of online digital creativity, such as mash-up, fanfiction, or machinimia. The Committee on Intellectual Property Rights and the Emerging Information Infrastructure considered that the notion of copying might not be an appropriate mechanism for achieving the goals of copyright in the digital age. Among the reasons of the inadequacy of the notion, the Committee highlights that "in the digital world copying is such an essential action, so bound up with the way computers work, that control of copying provides, in the view of some, unexpectedly broad powers, considerably beyond those intended by the copyright law."[34] As sharing becomes a basic form of human interaction to an emerging digital culture, Lessig

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erty and Growth 5 (May 2011), *available at* https://www.gov.uk/government/uloads/system/uploads/attachment_data/file/32563/ipreview-finalreport.pdf.

[32] *See, e.g.*, Pamela Samuelson, *The Copyright Principles Project: Directions for Reform*, 25 BERKELEY TECH. L. J. 1175, 1175-1245 (2010); WILLIAM PATRY, HOW TO FIX COPYRIGHT (Oxford U. Press 2012); Guy Pessach, *Reciprocal Share-Alike Exemptions in Copyright Law*, 30 CARDOZO L. REV. 1245, 1245-1293 (2008); Jessica Litman, *Sharing and Stealing*, 27 HASTINGS COMM. & ENT. L. J. 1, 1-48 (Fall 2004); Mark Lemley & Anthony Reese, *Reducing Digital Copyright Infringement Without Restricting Innovation*, 56 STAN. L. REV. 1345, 1345-1426 (May 2004); William M. Landes and Richard A. Posner, *Indefinitely Renewable Copyright*, 70 U. CHI. L. REV. 471, 471-518 (2003).

[33] Legal scholars have long recognized that copyright and patent are n ot the only options. *See, e.g.*, MICHELE BOLDRIN AND DAVID K. LEVINE, Agai nst Intellectual Monopoly (Cambridge University Press 2008) (disputing th e utility of intellectual property altogether); Stephen Breyer, *The Uneasy Case for Copyright: A Study of Copyright in Books, Photocopies, and Co mputer Programs*, 84 HARV. L. REV. 281, 282 (1970) (concluding "[i]t wo uld be possible, for instance, to do without copyright, relying upon author s, publishers, and buyers to work out arrangements among themselves tha t would provide books' creators with enough money to produce them."); J on M. Garon, *Normative Copyright: A Conceptual Framework for Copyri ght Philosophy and Ethics*, 88 CORNELL L. REV. 1278, 1283 (2003) (noting "[u]nless there is a valid conceptual basis for copyright laws, there can b e no fundamental immorality in refusing to be bound by them..."); JOOST SMIERS AND MARIEKE VAN SCHIJNDEL, IMAGINE THERE IS NO COPYRIGHT AND N O CULTURAL CONGLOMERATES TOO (Institute of Network Culture 2009); Joos t Smiers and Marieke Van Schijndel, *Imagining a World Without Copyri ght: the Market and Temporary Protection, a Better Alternative for Artis ts and Public Domain, in* Copyright and Other Fairy Tales: Hans Christia n Andersen and the Commodification of Creativity 129 (Helle Porsdam ed., Edward Elgar 2006). For an historical and empirical argument against c opyright, see Frank Thadeusz, *No Copyright Law: The Real Reason for Germany's Industrial Expansion*, SPIEGEL ONLINE (Aug. 18, 2010), *availabl e at* http://www.spiegel.de/international/ zeitgeist/0,1518,710976, 00.html.

[34] NATIONAL RESEARCH BOARD, THE DIGITAL DILEMMA: INTELLECTUAL PROPERTY IN THE INFORMATION AGE 140 (National Academy Press 2000).

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has called for an overhaul of the copyright system, which will "never work on the internet" and "[i]t'll either cause people to stop creating or it'll cause a revolution."[35]

Ubiquitous technology, cost minimization, and User-Generated Content UGC radically affected the traditional market failure that copyright is supposed to cure, both at the creation and distribution levels. The Internet instituted new economics of distribution for digital content.[36] Distribution and reproduction marginal costs being close to zero potentially eliminates—or at least strongly reduces—the need for third-party investment. In *The Creative Destruction of Copyrights*, Raymond Ku applies the metaphor of Schumpeter's wind of creative destruction to the digital revolution and wonders whether a copyright monopoly at close to zero marginal cost is still a sustainable option.[37] Ku concludes that—absent the need for encouraging content distribution—the artificial scarcity created by copyright cannot find social reasons for existence. In any event—from a less radical perspective—if technological innovation led to a substantial reduction in production, reproduction and distribution costs of cultural artifacts, a case could be made at least against the steady copyright monopoly's expansion that have been occurring for the past few decades.

In addition, minimization of reproduction and distribution costs affected traditional welfare analysis regarding creative incentive. Reductions in the production and distribution costs of original expressive works encourages non-professional authors to create.[38] Therefore, the number of authors for whom the lucre of

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[35] *See* Larry Lessig, Facilitating Access to Culture in the Digital Age, Speech at the WIPO Global Meeting on Emerging Copyright Licensing Modalities, Geneva, Switzerland (Nov. 4, 2010) (transcript *available at* http://www.freedomtodiffer.com/freedom_to_differ/2010/11/larry-lessig-calls-for-wipo-to-lead-radical-overhaul-of-copyright-law.html).

[36] *See* Sacha Wunsch-Vincent, *The Economics of Copyright and the Internet: Moving to an Empirical Assessment Relevant in the Digital Age* 2 (World Intell. Prop. Org., Economic Research Working Paper No. 9, 2013).

[37] *See* Raymond S. R. Ku, *The Creative Destruction of Copyrights: Napster and the New Economics of Digital Technology*, 69 U. CHI. L. REV. 263, 300-05 (2002); Raymond S. R., Ku, *Consumers and Creative Destruction: Fair Use Beyond Market Failure*, 18 BERKELEY TECH. L. J. 539, 539-574 (2003); *see also* Paul Ganley, *The Internet, Creativity and Copyright Incentives*, 10 J. INTELL. PROP. RTS. 188, 188-197 (2005); John F. Duffy, *The Marginal Cost Controversy in Intellectual Property*, 71 U. CHI. L. REV. 37, 37-56 (2004).

[38] *See* Tom W. Bell, *The Specter of Copyism v. Blockheaded Authors: How*

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copyright proves a necessary stimulus should drop. Additionally, low marginal costs empower few authors to reach a broader audience. If decentralized and unprofessional authors increasingly satisfy the market demand—because non-monetary incentives stimulate creation—a copyright monopoly will eventually prove superfluous, at least for these works. The burdens of a copyright monopoly will exceed its benefits, at least for works created by decentralized and non-professional authors.

III. REIMAGINING USERS

Quite provocatively, Lindberg and Patterson argued that the true nature of copyright law is to be a users' right.[39] However, as Julie Cohen noted, "[c]opyright doctrine [. . .] is characterized by the absence of the user [. . .] the resulting imbalance—empty space where one cornerstone of a well-balanced copyright edifice should be—makes for bad theory, bad policy, and bad law."[40] In particular, the marginalization of the user has reverberated on the role of the user in the legislative process. The public has always had very limited access to the bargaining table when copyright policies had to be enacted. This is due to the dominant mechanics of lobbying that largely excluded the users from any decision on the future of creativity management.[41] In accordance with Mançur Olson classical work, copyright policy is driven by a small group of concentrated players to the detriment of the more dispersed interest of smaller players and the public at large.[42] The consequence of users' marginality reflects on democratization. Boyle made this point straightforward by noting:

User-Generated Content Affects Copyright Policy, 10 VAND. J. ENT. & TECH. L. 841, 851-55 (2008).

[39] *See* RAY L. PATTERSON AND STANLEY W. LINDBERG, The Nature of Copyright: A Law Of Users' Rights (University of Georgia Press 1991).

[40] Julie Cohen, *The Place of the User in Copyright Law*, 74 FORDHAM L. REV. 347, 347-48 (2005).

[41] For an account of copyright industry political influence in the U.S. and worldwide, *see* JESSICA LITMAN, DIGITAL COPYRIGHT 22-69, 122-50 (Prometheus Books 2001); *see also* Neil Netanel, *Why Has Copyright Expanded: Analysis and Critique*, in 6 NEW DIRECTIONS IN COPYRIGHT LAW 3-11 (Fiona Macmillan ed., Edward Elgar Publishing 2007); JAMES BOYLE, THE PUBLIC DOMAIN: ENCLOSING THE COMMONS OF THE MIND 50-51 (Yale University Press 2009).

[42] *See* MANÇUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (Harvard U. Press 1971) (1965).

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> [i]n both environmental protection and intellectual property, the very structure of the decision making process tends to produce a socially undesirable outcome. Decisions in a democracy are made badly when they are primarily made by and for the benefit of a few stakeholders, be they landowners or content providers. It is a matter of rudimentary political science analysis or public choice theory to say that democracy fails when the gains of a particular action can be captured by a relatively small and well-identified group while the losses—even if larger in the aggregate—are low-level effects spread over a larger, more inchoate group. This effect is only intensified when the transaction costs of identifying and resisting the change are high.[43]

As a related problem, often the copyright legislative process has appeared to be biased by a large amount of lack of transparency and due process. The Anti-Counterfeiting Trade Agreement (ACTA) was a good example of secrecy in the process of enacting copyright and intellectual property laws.[44] ACTA was a secret treaty—negotiated away from the UN, behind closed doors—that could impinge heavily on citizens' freedoms and privileged uses. Nevertheless, users were completely excluded from the bargaining table, while information on the negotiations and relevant provisions included in the agreement have been for long time scarce and contradictory.

Further, commentators argued that copyright law is too obscure and complex for the users.[45] Copyright law is drafted for the market players, not for users. Let's take as an example Article 6(4) of the Information Society Directive. Lucie Guibault describes it as "extremely complex, vague and prone to interpreta-

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[43] *See* BOYLE, *supra* note 41, at 110.

[44] *See* Luc Pierre Devigne, Pedro Velasco-Martins and Alexandra Iliopoulou, *Where Is ACTA Taking US? Policies and Politics, in* COPYRIGHT ENFORCEMENT AND THE INTERNET 39-40 (Irini A. Stamatoudi ed., Wolters Kluwer 2010).

[45] *See* Litman, *supra* note 22, at 3-5, 33-34 (2010) (calling for a radical simplification of copyright law "unless our goal is to make it impossible for creators, distributors, and readers to navigate the copyright system without representation").

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tion."[46] It is illustrative to observe that the provision refers to actions to be taken to ensure that users may benefit form exceptions and limitations with respect to works protected by technological protection measures. Often, the obscurity of copyright law causes a high level of uncertainty among users regarding what they can or cannot do with creative content. Fair uses become "feared uses," when complexity of copyright provisions discourage users from enforcing privileged or fair uses. Meanwhile, copyright morphs from a defensive legal tool into an offensive tool to promote market dominance. Increasing users' involvement in the creative process exacerbates this imbalance. The Internet 2.0 and user-generated platforms have made everybody a potential author as well as a potential infringer. Therefore, heavily technical legislation is increasingly enforced against users.

Lobbying from cultural conglomerates played a key role in amplifying the process of copyright expansion beyond strict public interest. Public domain's enclosure has resulted from the asymmetric distribution of power in IP politics and the difficulty of representing public interest due to an unbalanced legislative process. So far, copyright matters have been considered entertainment industry sector specific issues. The absence of the users reflected into a pro-distributors copyright system, featuring an overbroad expansion of private property rights and corresponding restriction of public prerogatives.

Today, however, the community is reclaiming—and regaining—its role in the discourse about creativity. Users drove Internet change. They brought about a bottom-up revolution that challenged traditional social and market mechanics based on an opposite top-down paradigm. Mass culture and networked collaboration emphasize the centrality of the user in post-modern creativity. Then, the digital environment saw the emergence—or re-emergence—of a concept of authorship mingling users and authors together. Therefore, as copyright moves into the digital

[46] Lucie Guibault, Evaluating Directive 2001/29/EC in the light of the Digital Public Domain, paper presented at the 1st COMMUNIA Conference (July 1, 2008), at 10; *see also* Lucie Guibault et al., *Study on the Implementation and Effect in Member States' Laws of Directive 2001/29/EC on the Harmonisation of Certain Aspects of Copyright and Related Rights in the Information Society* 105 (report prepared for the European Commission, ETD/2005/IM/D1/91, Feb. 2007).

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age, the absence of the user has begun to matter profoundly and "a theory of authors' rights must be informed by a theory of user as well."[47]

First, a politics of users—and inclusive—rights should be primarily based on cleansing the legislative process from the dominance of the market.[48] This might be achieved by seeking transparency through an evidence-based approach in policy making. In this regard, a welfare cost-benefit analysis could become a prerequisite for enacting new legislation. In particular, legislators should base decisions only on independent empirical evidence showing whether the creative market as a whole—rather than niches and lobbying groups—might justify policy reforms or new enforcement strategies.[49] Even if sellers' revenues decreased what should matter for policy purposes, should only be the surplus consumers derive—in particular whether policy strategies encourage or not creative output. Actually, this policy approach would endorse constitutional prescriptions in the United States and dominant welfare theory principles in Europe and elsewhere. Obviously, if strictly applied, this approach might lead to substantially different policy strategies than the current.[50] Also, users' representation should be enhanced in the policy making process. Options are plenty and easy to enforce. For example, the creation of advisory bodies, such as the German KulturRat,[51]

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[47] Cohen, *supra* note 40, at 348.

[48] Indeed, this is a structural problem extending beyond creativity related policy. *See* LAWRENCE LESSIG, REPUBLIC LOST: HOW MONEY CORRUPTS CONGRESS – AND A PLAN TO STOP IT (2011) (discussing imbalances caused by lobbying in the Congress as a natural development of having spearheaded a movement for the protection of digital user rights against copyright over-expansion because the primary problem with modern intellectual property policies is the invisibility of the users and the marginalization of public interest within the legislative process).

[49] *See The Copyright Evidence Wiki: Empirical Evidence for Copyright Policy* (Theo Koutmeridis, Kris Erickson, and Martin Kretschmer eds., CREATE Centre: University of Glasgow 2015), *available at* www.CopyrightEvidence.org (last visited Dec. 15, 2016) (trying to establish a body of evidence that allows better decision making in the contested copyright policy field); *see also* Raymond Shih Ray Ku, Jiayang Sun, and Yiying Fan, *Does Copyright Law Promote Creativity – An Empirical Analysis of Copyright's Bounty*, 62 VAND. L. REV. 1669, 1669-1746 (2009) (noting that there's no consistent relationship between copyright protection and output).

[50] Joel Waldfogel, *Bye, Bye, Miss American Pie: The Supply of New Recorded Music since Napster* 24, (NBER Working Paper Series No. 16882, Mar. 2011) (noting that it is "clear that creative output in recorded music is as high, or higher, than it was prior to Napster").

[51] *See* http://www.kulturrat.de

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might strengthen users' representation. Again, a public interest or public domain supervisor—whose mandatory opinion would be requested to formulate and enact knowledge-based policies—might act as a guardian of users' fundamental rights.[52]

Second, this theory should help reconciling a paradigm of exclusive rights to one of inclusive rights, policing creativity from a communitarian rather than an individualistic perspective. The regained emphasis on the community in digital creativity elevates users' rights as the *Grundnorm* of creativity policies,[53] rather than the exception. Policy makers should be prepared to ask whether the user "would be better served by a system that limits the rights of copyright owners more narrowly in the first instance."[54] A few policy options have been proposed to achieve this goal.

A. A Return to Formalities?

Many suggested that a return to formalities might ease the weaknesses of the current copyright regime. According to these proposals, published works would not be copyrighted, unless the authors comply with some simple, cheap and non-discriminatory formalities.[55] The idea of a registration system for creative works through global online copyright registries is increasingly gaining momentum.[56] Formalities might become an opportunity for creativity in the digital era as technology overcame most

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[52] *See* Alexander Peukert, *A European Public Domain Supervisor*, 42 INT'L REV. INTEL. PROP. COMP. L. 125, 125-129 (2011).

[53] *See* HANS KELSEN, GENERAL THEORY OF LAW AND STATE (Harvard U. Press 1949).

[54] Cohen, *supra* note 40, at 374.

[55] *See, e.g.*, Christopher Sprigman, *Reform(aliz)ing Copyright*, 57 STAN. L. REV. 485 (2004) (proposing an optional registration system that subjects unregistered works to a default licence under which the use of the work would trigger only a modest statutory royalty liability); LAWRENCE LESSIG, FREE CULTURE: HOW BIG MEDIA USES TECHNOLOGY AND THE LAW TO LOCK DOWN CULTURE AND CONTROL CREATIVITY 140 (Penguin Press 2004); LAWRENCE LESSIG, THE FUTURE OF IDEAS: THE FATE OF THE COMMONS IN A CONNECTED WORLD (pincite missing) (Vintage Books 2002); Lewis Hyde, *How to Reform Copyright*, THE CHRONICLE (Oct. 9, 2011), *available at* http://chronicle.com/article/How-to-Reform-Copyright/129280 (last visited Jan. 28, 2018);

[56] *See* ANDREW GOWERS, GOWERS REVIEW OF INTELLECTUAL PROPERTY (HM Treasury, Nov. 2006), at Recommendation 14b (endorsing the establishment of a voluntary register of copyright), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228849/0118404830.pdf.

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discriminatory hurdles that persuaded the international community to abolish them in the analog world.[57] A return to formalities would endorse a user-centered approach to copyright policy that promotes UGC creativity. A modern registration system may enrich the public domain, enhance access and reuse, and avoid transaction costs burdening digital creativity. Registration could be a precondition for protection. Alternatively, registration might at least be required as a precondition of extension of protection.[58]

In *Making Copyright Fit for the Digital Agenda*, Marco Ricolfi's designed an alternative copyright default rule, coupled with the implementation of a formality and registration system, that goes by the name of Copyright 2.0.[59] Other scholars, such as Lessig, made also similar proposals.[60] In Ricolfi's Copyright 2.0, traditional copyright, or Copyright 1.0, is still available. Copyright 1.0 must be claimed by the creator at the onset, for example by inserting a copyright notice before the first publication of a work. At certain conditions, the Copyright 1.0 notice could also be added after the first publication, possibly during a specified and short grace period. The Copyright 1.0 protection given by the original notice is deemed withdrawn after a specified brief period of time, unless an extension period is formally requested through an Internet based renewal and

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[57] *See* Stef van Gompel, *Formalities in the digital era: an obstacle or opportunity?*, *in* GLOBAL COPYRIGHT: THREE HUNDRED YEARS SINCE THE STATUTE OF ANNE, FROM 1709 TO CYBERSPACE 395-424 (Lionel Bently, Uma Suthersanen and Paul Torremans eds., Edward Elgar 2010) (arguing that the pre-digital objections against copyright formalities cannot be sustained in the digital era); *see also* Takeshi Hishinuma, *The Scope of Formalities in International Copyright Law in a Digital Context*, *in* GLOBAL COPYRIGHT: THREE HUNDRED YEARS SINCE THE STATUTE OF ANNE, FROM 1709 TO CYBERSPACE 460-467 (Lionel Bently, Uma Suthersanen and & Paul Torremans eds., Edward Elgar 2010).

[58] See Lawrence Lessig, Recognizing the Fight We're In, Speech at the Open Rights Group Conference, London, UK (Mar. 24, 2012) (*available at* http://vimeo.com/39188615, at 36:40-38:28) (proposing the reintroduction of formalities at least to secure extensions of copyright, if legislators decide to introduce them).

[59] *See* Marco Ricolfi, Making Copyright Fit for the Digital Agenda, *in* 82 IL DIRITTO D'AUTORE 359, 359-72 (2011); *see also* Marco Ricolfi, *Copyright Policies for Digital Libraries in the Context of the i2010 Strategy* 6 (The 1st COMMUNIA Conference, Discussion Paper, July 1, 2008), *available at* http://www.communia-project.eu/node/110.

[60] *See* LAWRENCE LESSIG, REMIX: MAKING ART AND COMMERCE THRIVE IN THE HYBRID ECONOMY 253-265 (Bloomsbury Publishing 2008) (proposing different routes for professional, remix and amateur authors, registries, and the re-introductuìion of formalities and an opt-in system).

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registration procedure, whose registration data will be accessible online. If no notice is given—or no extension is sought—Copyright 2.0 applies, providing creators with the right to attribution.

B. Mandatory Exceptions for UGC

As Cohen has argued, a user-centered approach to traditional copyright doctrines "would understand 'publicness' as hinging importantly on a resource's practical accessibility, and would observe that copyrighted cultural goods, and especially mass commercial culture, comprise an increasingly large fraction of the public experience of culture."[61] In this respect, mandatory exceptions have been claimed as a solution for user-generated content, together with the use of informal copyright practices.[62]

Proposals have been made for introducing an exception for transformative use in user-generated works.[63] Canada introduced a specific exception to this effect. The Canadian copyright law now allows the use of a protected work—which has been published or otherwise made available to the public—in the creation of a new work, if the use is done solely for non-commercial purposes and does not have substantial adverse effects on the potential market for the original work.[64] Likewise, the U.S. Copyright Office rulemaking on the DMCA

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[61] Cohen, *supra* note 40, at 368.

[62] *See, e.g.*, Edward Lee, *Warming Up to User-Generated Content*, 2008 U. ILL. L. REV. 1459, 1462 (2008) (noting that "informal copyright practices-i.e., practices that are not authorized by formal copyright licenses but whose legality falls within a gray area of copyright law—effectively serve as important gap fillers in our copyright system"); Steven A. Hetcher, *Using Social Norms to Regulate Fan Fiction and Remix Culture*, 157 U. PA. L. REV. 1869, 1869-1934 (2009).

[63] *See* Warren B. Chik, *Paying it Forward: The Case for a Specific Statutory Limitation on Exclusive Rights for User-Generated Content Under Copyright Law*, 11 J. MARSHALL REV. INTELL. PROP. L. 240, 240-294 (2011); Daniel Gervais, *The Tangled Web of UGC: Making Copyright Sense of User-Generated Content*, 11 VAND. J. ENT. & TECH. L. 841, 861-869 (2009); Debora Halbert, *Mass Culture and the Culture of the Masses: A Manifesto for User-Generated Rights*, 11 VAND. J. ENT. & TECH. L. 921, 934-953 (2009); Mary W. S. Wong, *"Transformative" User-Generated Content in Copyright Law: Infringing Derivative Works or Fair Use?*, 11 VAND. J. ENT. & TECH. L. 1075, 1075-1139 (2009).

[64] *See* An Act to Amend the Copyright Act, 2010, Bill C-32 (Can.), Art. 22; *see also* Peter Yu, *Can the Canadian UGC Exception Be Transplanted Abroad?*, 26 INTELL. PROP. J. 177, 177-205 (2014) (discussing also a Hong Kong proposal for a UGC exception).

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anti-circumvention provisions recently introduced an exception for the use of movie clips for transformative, non-commercial works—making vidding easier—and the European institutions and stakeholders have been recently discussing a specific exception for UGC.[65]

Also, general fair use exception clauses, if properly construed, may prove effective to give UGC creators some breathing space. In particular, recent U.S. case law protects UGC creators from bogus DMCA takedown notices in cases of blatant misrepresentation of fair use defences by copyright holders. In *Lenz v. Universal Music*, the 9th Circuit ruled that "the statute requires copyright holders to consider fair use before sending takedown notification."[66] The Court also recognised the possible applicability of section 512(f) of the DMCA that allows for the recognition of damages in case of proved bad-faith, which would occur if the copyright holder did not consider fair use or paid "lip service to the consideration of fair use by claiming it formed a good faith belief when there is evidence to the contrary."[67]

IV. REIMAGINING ACCESS

Mostly driven by scholarly efforts, an Access to Knowledge (A2K) Movement, an Open Access Publishing (OAP) Movement, a Public Domain Project and Cultural Environmentalism sought to re-define the hierarchy of priorities embedded in the traditional politics of intellectual property. They promoted a vision that tips the balance in favor of the access factor of the copyright

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[65] *See* United States Copyright Office, *Rulemaking on Exemptions from Prohibition on Circumvention of Technological Measures that Control Access to Copyrighted Works* (July 26, 2010), *available at* http://www.copyright.gov/1201/2010; Commission, *Report on the Responses to the Public Consultation on the Review of the EU Copyright Rules* (July 2014), at 68 (EU), *available at* https://www.yumpu.com/en/document/view/30151098/zzeia/69 (noting that respondents often favour a legislative intervention, which could be done "by making relevant existing exceptions (parody, quotation and incidental use and private copying are mentioned) mandatory across all Member States or by introducing a new exception to cover transformative uses"); *see also* Commission Communication on Content in the Digital Single Market, at 3-4, COM (2012) 789 final (Dec. 18, 2012) (EU) (proposing micro-licensing arrangements that were later sidelined).

[66] Stephanie Lenz v. Universal Music Corp., 801 F.3d 1126, 1131 (9th Cir. 2015).

[67] *Id*., at 17-18 (noting also that there's no liability under § 512(f), "[i]f, however, a copyright holder forms a subjective good faith belief the allegedly infringing material does not constitute fair use").

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paradox.[68] Apparently, all these movement find their justification in a cultural theory approach to intellectual property policy, seeking enhanced "distributive justice" beyond the progressive but market-based approach of more traditional welfare and utilitarian theories.[69] Supposedly—once again—creativity would thrive through the power of imitation, open access, easier reuse and technological innovation would serve as a prism multiplying social value.

A. Access to Knowledge (A2K)

As Nelson Mandela once noted, "eliminating the distinction between the information-rich and information-poor is . . . critical to eliminating economic and other inequalities between North and South, and to improving the life of all humanity."[70] Since a 1961 Brazilian draft resolution,[71] Access to Knowledge (A2K) has become a question of major international concern as "access to learning and knowledge [are] key elements towards the improvement of the situation of under privileged countries."[72] In addition, copyright expansion, cultural appropriation, and dysfunctional access to scientific and patented knowledge do heighten the North-South cultural divide. As a consequence, A2K emerged as a globalized movement that "takes concerns with copyright law and other regulations that affect knowledge" and aims at promoting redistribution of informational resources in favor of minorities and the Global South[73] In this sense, the A2K

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[68] *See* Christophe Geiger, *Copyright as an Access Right: Securing Cultural Participation through the Protection of Creators' Interests*, *in* WHAT IF WE COULD REIMAGINE COPYRIGHT? (Rebecca Giblin and Kimberlee Weatherall eds., ANU Press, 2017) (discussing the notion of copyright as an access right and proposing solutions to enhance access within the copyright paradox).

[69] *See* William Fisher, *Theories of Intellectual Property*, in NEW ESSAYS IN THE LEGAL AND POLITICAL THEORY OF PROPERTY 168-199 (Stephen Munzer ed., CUP 2001).

[70] Nelson Mandela, Speech at TELECOM 95, Geneva (Oct. 3, 1995), quoted in ERNEST J. WILSON, III, THE INFORMATION REVOLUTION AND DEVELOPING COUNTRIES 1 (2004).

[71] *See* GRAHAM DUTFIELD AND UMA SUTHERSANEN, GLOBAL INTELLECTUAL PROPERTY LAW 277 (Edward Elgar 2008).

[72] Draft Report of the Provisional Committee on Proposals Related to a WIPO Development Agenda of the World Intellectual Property Organization 6 (World Intellectual Property Organization, African Group Statement).

[73] Consumer Project on Technology, *Access to Knowledge Movement, available at* http://www.cptech.org/a2k (last visited Jan. 28, 2018); *see also* ACCESS TO KNOWLEDGE IN THE AGE OF INTELLECTUAL PROPERTY (Gaëlle Krikorian and & Amy Kapczynski eds., Zone Books 2011); ACCESS TO KNOWLEDGE IN AFRICA:

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movement might be construed as an umbrella notion under which other endeavours, such the OAP Movement or the Public Domain Project, can be re-comprehended, in pursuit of the establishment of a cultural theory approach to policies for creativity.

International working projects have tried to address the requests of the A2K movement under the framework of Article 27 of the Universal Declaration of Human Rights, stating that "everyone has the right freely to participate in the cultural life of the community, to enjoy the arts and to share in scientific advancement and its benefits."[74] As part of the discussions leading to the adoption of the WIPO Development Agenda,[75] activists produced a document to start negotiations on a Treaty on Access to Knowledge.[76] The proposed treaty is based on the core idea that "restrictions on access ought to be the exception, not the other way around," and that "both subject matter exclusions from, and exceptions and limitations to, intellectual property protection standards are mandatory rather than permissive."[77] Consensus on the A2K Treaty does appear hard to reach; however, a narrow version was signed in Marrakesh in 2013 to promote the use of protected works by disabled persons.[78]

B. Open Access Publishing (OAP)

Although international agreement on an A2K Treaty may be hard to reach, grass-roots movements spearheaded similar goals through different routes. A quest for open access to academic knowledge occupied the recent agenda of a global network of institutions and stakeholders. At CERN in Geneva, Lawrence

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THE ROLE OF COPYRIGHT (Chris Armstrong, Jeremy de Beer, Dick Kawooya, Achal Prabhala, and Tobias Schonwetter eds., UCT Press 2010); Amy Kapczynski, *The Access to Knowledge Mobilization and The New Politics of Intellectual Property*, 117 YALE L. J. 80, 804-83 (2008).

[74] *See* Universal Declaration of Human Rights, G.A. Res. 217A (III), U.N. Doc. A/810 at 71 (1948), Art. 27.

[75] *See* Development Agenda for WIPO, *available at* http://www.wipo.int/ip-development/en/agenda.

[76] *See* Proposed World Intellectual Property Organization Treaty on Access to Knowledge (May 9, 2005) (Draft), *available at* www.cptech.org/a2k/a2k_treaty_may9.pdf.

[77] Laurence R. Helfer, *Toward a Human Rights Framework for Intellectual Property*, 40 U.C. DAVIS L. REV. 971, 1013 (2007).

[78] *See* Marrakesh Treaty to Facilitate Access to Published Works for Persons Who Are Blind, Visually Impaired or Otherwise Print Disabled (July 27, 2013), *available at* www.wipo.int/treaties/en/ip/marrakesh.

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Lessig reminded the audience of scientists and researchers that most scientific knowledge is locked away for the general public and can only be accessed by professors and students in a university setting. Lessig pungently made the point that "if you are a member of the knowledge elite, then there is free access, but for the rest of the world, not so much [. . .] publisher restrictions do not achieve the objective of enlightenment, but rather the reality of 'elite-nment.'"[79] Other authors have reinforced this point. John Willinsky, for example, suggested that, as its key contribution, open access publishing (OAP) models might move "knowledge from the closed cloisters of privileged, well-endowed universities to institutions worldwide."[80]

The dramatic increase in prices for journals and publisher restrictions to the reuse of information inspired—and motivated—the OAP movement in scholarly publishing.[81] The academics' reaction against the 'cost of knowledge'—also known as the serial crisis—is on the rise, especially against the practice of charging 'exorbitantly high prices for [. . .] journals' and of 'sell[ing] journals in very large bundles'.[82] George Monbiot stressed the unfairness of the academic publishing system by noting, with specific reference to publishers such as Elsevier, Springer, or Wiley-Blackwell: [w]hat we see here is pure rentier capitalism: monopolising a public resource then charging exorbitant fees to use it. Another term for it is economic parasitism. To

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[79] Lawrence Lessing, The Architecture of Access to Scientific Knowledge: Just How Badly we Have Messed This Up, Speech at CERN Colloquium and Library Science Talk, (Apr. 18, 2011) (transcripts *available at* http://cdsweb.cern.ch/record/1345337); *see also* Lawrence Lessig, Recognizing the Fight We're In, Speech delivered at the Open Rights Group Conference, London, UK (Mar. 24, 2012) (*available at* http://vimeo.com/39188615).

[80] JOHN WILLINSKY, THE ACCESS PRINCIPLE: THE CASE FOR OPEN ACCESS TO RESEARCH AND SCHOLARSHIP 33 (MIT PRESS 2006).

[81] See GIANCARLO F. FROSIO, Open Access Publishing: A Literature Review (Centre for Copyright and New Business Models in the Creative Econ., Working Paper 2014/1, 2014), *available at* http://www.create.ac.uk/publications/open-access-publishing-a-literature-review (providing a book length overview of the OAP movement and several open-access initiatives and projects, economics of academic publishing and copyright implications, OAP business models, and OAP policy initiatieves).

[82] *See* The Cost of Knowledge, Researchers Taking a Stand against Elsevier, http://thecostofknowledge.com (last visited Jan., 28, 2018); *The Price of Information: Academics are Starting to Boycott a Big Publisher of Journals*, THE ECONOMIST (Feb. 4, 2012), http://www.economist.com/node/21545974; *see also* Eyal Amiran, *The Open Access Debate*, 18 Symploke 251, 251-260 (2011) (reporting several other examples of these reactions and boycotts).

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obtain the knowledge for which we have already paid, we must surrender our feu to the lairds of learning.[83]

According to Monbiot, this economic parasitism results from a monopoly over content that the academic publishers do not create and do not pay for.[84] Researchers, hoping to publish with reputable journals, surrender their copyrights for free. Most of the times, the production of that very content—now monopolized by the academic publishers—was funded by the public, through government research grants and academic incomes. This led some authors to discuss the opportunity of abolishing copyright for academic works all together.[85] From the ancient proverbial idea of *scientia donum dei est unde vendi non potest* to the emergence of the notion of 'open science', the normative structure of science presents an unresolvable tension with the exclusive and monopolistic structure of intellectual property entitlements. Merton powerfully emphasized the contrast between the ethos of science and intellectual property monopoly rights:

> "Communism," in the nontechnical and extended sense of common ownership of goods, is a second integral element of the scientific ethos. The substantive findings of science are a product of social collaboration and are assigned to the community. They constitute a common heritage in which the equity of the individual producer is severely limited. An eponymous law or theory does not enter into the exclusive possession of the discoverer and his heirs, nor do the mores bestow upon them special rights of use and disposition. *Property rights in science are whittled down to a bare minimum by the rationale of the scientific ethic*. The scientist's claim to "his" intellectual "property" is limited to that of recognition and esteem which, if the institution functions with a modicum of efficiency, is roughly commensurate with the signifi-

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[83] *See* George Monbiot, *Academic Publishers Make Murdoch Look like a Socialist*, THE GUARDIAN (Aug. 29, 2011), http://www.guardian.co.uk/commentisfree/2011/aug/29/academic-publishers-murdoch-socialist.

[84] *Id.*

[85] *See* Steven Shavell, *Should Copyright of Academic Works Be Abolished?* 2 J. LEGAL ANALYSIS 301, 301-58 (2010).

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> cance of the increments brought to the common fund of knowledge.[86]

The Berlin Conferences gave a major propulsion to OA. Most significantly, they resulted in the *Berlin Declaration on Open Access to Knowledge in the Sciences and Humanities*, including the goal of disseminating knowledge through the open access paradigm via the Internet.[87] OAP refers to free and unrestricted worldwide electronic distribution and availability of peer-reviewed journal literature. The Budapest Open Access Initiative (OAI) uses a definition that includes free reuse and redistribution of "open access" material by anyone.[88] According to Peter Suber, the *de facto* spokesperson of the OAP movement,[o] pen access (OA) is free online access [. . .] OA literature is not only free of charge to everyone with an internet connection, but free of most copyright and licensing restrictions. OA literature is barrier-free literature produced by removing the price barriers and permission barriers that block access and limit usage of most conventionally published literature, whether in print or online.[89]

OAP has been growing at staggering rate since 2001, when the OAI was first promoted. There are now almost ten thousand open access journals.[90] OAP arrangements have been increasingly endorsed by governmental institutions,[91] in light of the fact that economic studies shown a positive net value of OAP models when compared to other publishing models.[92] The European

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[86] Robert K. Merton, *The Normative Structure of Science*, *in* THE SOCIOLOGY OF SCIENCE: THEORETICAL AND EMPIRICAL INVESTIGATIONS 273 (U. Chicago Press 1979) (1942); *see also* James Boyle, *Mertonianism Unbound, Imagining Free, Decentralized Access to Most Cultural and Scientific Material, in* UNDERSTANDING KNOWLEDGE AS A COMMONS: FROM THEORY TO PRACTICE 124 (Charlotte Hess and & Elinor Ostrom eds., MIT Press 2006).

[87] *See* Berlin Declaration on Open Access to Knowledge in the Sciences and Humanities, Berlin Conference, Berlin (Oct. 20-22, 2003) , *available at* http://oa.mpg.de/lang/en-uk/berlin-prozess/berliner-erklarung.

[88] Budapest Open Access Initiative, Budapest, Hungary (Feb.14, 2002) *available at* http://www.budapestopenaccessinitiative.org

[89] Peter Suber, *Creating an Intellectual Commons Through Open Access*, *in* Understanding Knowledge as a Commons: From Theory to Practice 171 (Charlotte Hess and Elinor Ostrom eds., MIT Press 2006).

[90] *See* DIRECTORY OF OPEN ACCESS JOURNALS (DOAJ), *available at* http://www.doaj.org (last visited Jan., 28, 2018).

[91] *See* Frosio, *supra* note 81, at 163-180.

[92] *See* JOHN HOUGHTON, OPEN ACCESS – WHAT ARE THE ECONOMIC BENEFITS? A COMPARISON OF THE UNITED KINGDOM, NETHERLANDS AND DENMARK (June 23, 2009) (report prepared for Knowledge Exchange) (showing that adopting an

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Commission, for example, plans to make OAP the norm for research receiving founding from its Horizon 2020 research programme.[93] As part of its *Innovation and Research Strategy for Growth,* the UK government has announced that all publicly funded scientific research must be published in OA journals.[94] In the US, the Consolidated Appropriations Act of 2008[95] instituted an OA mandate for research projects funded by the NIH.[96] Together with research articles, data, teaching materials, and the like, the importance of open access models extends also to books. Millions of historic volumes are now openly accessible from various digitization projects such as Europeana, Google Books, or Hathi.

Richard Nelson argued "the key to assuring that a large portion of what comes out of future scientific research will be placed in the commons is staunch defense of the commons by universities."[97] Nelson continues by arguing that if universities "have policies of laying their research results largely open, most of science will continue to be in the commons."[98] The role of universities in the OA and OAP movement is critical. Willinsky advocated the idea that universities and scholars have a responsibility to make their work available OA globally by referring to an "access principle."[99] The challenge ahead of the OAP movement

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open access model to scholarly publications could lead to annual savings of around €70 million in Denmark, €133 million in the Netherlands and €480 million in the United Kingdom); JOHN HOUGHTON WITH BRUCE RASMUSSEN AND PETER SHEEHAN, ECONOMIC AND SOCIAL RETURNS ON INVESTMENT IN OPEN ARCHIVING PUBLICLY FUNDED RESEARCH OUTPUTS (July 2010) (report prepared for The Scholarly Publishing & Academic Resources Coalition) (concluding that free access to U.S. taxpayer-funded research papers could yield $1 billion in benefits)

[93] *See* European Commission, *The Framework Programme for Researc h and Education*, Horizon 2000, *available at* https://ec.europa.eu/progra mmes/horizon2020/h2020-sections.

[94] *See* INNOVATION AND RESEARCH STRATEGY FOR GROWTH 76-78 (prepared by the Department for Business Innovation and Skills) (Dec. 2011); *see also* WORKING GROUP ON EXPANDING ACCESS TO PUBLISHED RESEARCH FINDINGS, ACCESSIBILITY, SUSTAINABILITY, EXCELLENCE: HOW TO EXPAND ACCESS TO RESEARCH PUBLICATIONS (FINCH REPORT) (June 2012).

[95] *See* Consolidated Appropriations Act of 2008 HR 2764.

[96] *See* National Institutes of Health *Revised Policy on Enhancing Public Access to Archived Publications Resulting from NIH-Funded Researc*h (Jan. 11, 2008), *available at* http://grants.nih.gov/grants/guide/notice-files/NOT-OD -08-033.html.

[97] Richard R Nelson, *The Market Economy, and the Scientific Commons*, 33 RESEARCH POLICY 455, 467 (2004).

[98] *Id.*

[99] WILLINSKY, *supra* note 80, at xii; *see also* PETER SUBER, OPEN ACCESS 1-49

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is to turn university environments—and the knowledge produced within—into a more easily and freely accessible public good, perhaps better integrating the OAP movement with Open University and Open Learning. Seeking to reap the full value that OA can yield in the digital environment, Jerome Reichman and Paul Uhlir proposed a model of Open Knowledge Environments (OKEs) for digitally networked scientific communication.[100] OKEs would "bring the scholarly communication function back into the universities" through "the development of interactive portals focused on knowledge production and on collaborative research and educational opportunities in specific thematic areas."[101]

C. Digital Libraries

OKEs might also serve the goal of open-access by contributing to reshape the role of libraries. Digital libraries—and the long-term goal of digitizing and making available online the entire corpus of human knowledge—stand as a critical milestone for the future development of the information society. They become essential to boost citizens' cultural empowerment and democratization, which hopefully the digital interconnected society will bring about. OAP and OEKs should make easier the creation of digital public libraries, possibly making the dream of the Digital Library of Alexandria come true.[102]

The creation of a public digital library versus the private model offered by Google has been widely discussed. Robert Darnton—the Harvard über-librarian—repeatedly called for the creation of a national digital library, despite acknowledging the difficulties of a public effort to digitize and connect all material

(MIT Press 2012) (discussing the emergence of this principle).

[100] *See* JEROME H. REICHMAN, TOM DEDEURWAERDERE, AND PAUL F. UHLIR, GOVERNING DIGITALLY INTEGRATED GENETIC RESOURCES, DATA, AND LITERATURE: GLOBAL INTELLECTUAL PROPERTY STRATEGIES FOR A REDESIGNED MICROBIAL RESEARCH COMMONS 441-67 (Cambridge U. Press, 2016).

[101] Paul F. Uhlir, Revolution and Evolution in Scientific Communication: Moving from Restricted Dissemination of Publicly-Funded Knowledge to Open Knowledge Environment, Speech at the COMMUNIA Conference (June 28, 2009).

[102] *Cf.* Giancarlo F. Frosio, *Google Books Rejected: Taking the Orphans to the Digital Public Library of Alexandria*, 28 SANTA CLARA HIGH TECH. L. J. 81, (2011).

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into a single resource.[103] Europeana—the EU digital library—is a key aspect the Digital Agenda of the European Union.[104] Digital public libraries should build upon the many ongoing non-profit digitization and digital preservation projects, such as the Library of Congress American Memory Project, the Online Books Page, the Hathi Trust Digital Library, Project Gutenberg, and the Million Books Project. Additionally, non-proprietary and open library projects extend beyond book repositories, such as the Internet Archive or the International Music Score Library Project. A public digital library should connect all these projects and offer a single access portal, together with a common policy for access and re-use.[105] A World Digital Public Library that integrates OKEs will push forth the rediscovery of currently unused or inaccessible works, open up the riches of knowledge in formats that are accessible to persons with disabilities and, empower democratization by favoring access regardless of market power.[106] However, libraries are increasingly consuming significant shares of their knowledge goods from globalized publishers according to the contractual and technological protection measures that these publishers impose on their digital content. Thus there is an unavoidable movement of enclosure regarding the provision of knowledge through libraries, all in a manner that practically compels libraries to take part in the privatization of knowledge supply and distribution.[107]

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[103] Robert Darnton, *Can we Create a National Digital Library?*, THE NEW YORK REVIEW OF BOOKS (Oct. 28, 2010), *available at* http://www.nybooks.com/articles/archives/2010/oct/28/can-we-create-national-digital-library.

[104] *See* Commission Communication, Europe 2020: A Strategy for Smart, Sustainable and Inclusive Growth, COM (2010) 2020 (Mar. 3, 2010); *see also* European Parliament and Council Directive 2012/28/EU on Certain Permitted Uses of Orphan Works, 2012 O.J. (L 299) 5 (Oct. 25, 2012) (enabling the use of orphan works after diligent search for public libraries digitization projects); Case C-117/13, Technische Universität Darmstadt v Eugen Ulmer KG, 2014 E.C.D.R. 23 (Sept. 11, 2013) (stating that European libraries may digitize books in their collection without permission from the rightholders with caveats).

[105] *See Berkman Center Announces Digital Public Library Planning Initiative*, BERKMAN KLEIN CENTER FOR INTERNET & SOCIETY AT HARVARD UNIVERSITY (Dec. 13, 2010), *available at* http://cyber.law.harvard.edu/newsroom/digital_public_library.

[106] For additional considerations on the creation of a World Digital Public Library, see Frosio, *supra* note 102, at 106-17.

[107] Pessach Guy, *The Role of Libraries in A2K: Taking Stock and Looking Ahead*, 2007 MICH. ST. L. REV. 257, 268 (2007).

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Therefore, the road to global access to knowledge is to provide digital libraries with a better framework to support their independence from commodification of knowledge. Nellie Kroes warns against the welfare loss of the immense cultural riches unveiled by digitization, nevertheless locked behind the intricacies of an outdated copyright model. "Think of the treasures that are kept from the public because we can't identify the right-holders of certain works of art. These "orphan works" are stuck in the digital darkness when they could be on digital display for future generations. It is time for this dysfunction to end."[108]

A return to formalities, registries and data collection might effectively ease the orphan works problem.[109] Today, technology enables the creation of global digital repositories that ensure the integrity of digital works, render filings user-friendly and inexpensive, and enable searches on the status of any creative work.[110] Measures to improve the provision of rights management information range from encouraging digital content metadata tagging, to promoting the use of creative commons-like licenses, and encouraging the voluntary registration of rights ownership information in specifically designed databases.[111] Many projects aim at increasing the supply of rights management information to the public, merging unique sources of rights information, and establishing specific databases for orphan works. Notably, the EU mandated project ARROW includes national libraries, publishers, writers' organizations and collective management organizations and aspires to find ways of identifying

[108] Nellie Kroes, Ending Fragmentation of the Digital Single Market, Speech at the Business for New Europe event, London, SPEECH/11/70 (Feb. 7, 2010).

[109] *See* Tanya Aplin, *A Global Digital Register for the Preservation and Access to Cultural Heritage: Problems, Challenges and Possibilities*, *in* COPYRIGHT AND CULTURAL HERITAGE: PRESERVATION AND ACCESS TO WORKS IN A DIGITAL WORLD 3-27 (Estelle Derclaye ed., Edward Elgar 2010); Caroline Colin, *Registers, Databases and Orphan Works*, *in* COPYRIGHT AND CULTURAL HERITAGE, *id.* at 28-50; Steven Hetcher, *A Central Register of Copyrightable Works: a U.S. Perspective*, *in* COPYRIGHT AND CULTURAL HERITAGE, *id* at 156-76.

[110] *See* GOWERS, *supra* note 56, at Recommendation 14b (endorsing the establishment of a voluntary register of copyright).

[111] *See* Gompel, *supra* note 57, at 11-14 (noting that only voluntary supply of information would be compliant with the no-formalities prescription of the Berne Convention).

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rightholders, determining and clearing rights, and possibly confirming the public domain status of a work.[112]

The implementation of a diligent search system and a mandatory exception as a defense to copyright infringement for the use of orphan works has been advocated in multiple jurisdictions. This arrangement implies that a bona fide/good faith user must conduct a diligent search prior to the use of the work to avoid liability. In the United States, proposals have been made following Copyright Office's recommendations but never adopted into law.[113] The High-Level Expert Group on the European Digital Libraries Initiative made similar recommendations: Member States are encouraged to establish a mechanism to enable the use of such works for non-commercial and commercial purposes, against agreed terms and remuneration, when applicable, if diligent search in the country of origin prior to the use of the works has been performed in trying to identify the work and/or locate the rightholders.[114]

Partially endorsing these principles, EU Directive on certain permitted uses of orphan works has adopted a diligent search standard for public digitization projects across Europe.[115] Broder solutions have been discussed. A British Screen Advisory Committee (BSAC)'s proposal would set up a compensatory liability regime based on 'best endeavours' to locate the copyright owner of a work.[116] If a rights owner emerges, he is entitled to claim a

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[112] *See Accessible Registries of Rights Information and Orphan Works*, ARROW, https://joinup.ec.europa.eu/document/accessible-registries-rights-information-and-orphan-works-arrow (creating registries of rights information and orphan works); BARBARA STRATTON, SEEKING NEW LANDSCAPES: A RIGHTS CLEARANCE STUDY IN THE CONTEXT OF MASS DIGITIZATION OF 140 BOOKS PUBLISHED BETWEEN 1870 AND 2010 5, 35-36 (British Library 2011) (showing that in contrast to the average four hours per book to undertake a diligent search, "the use of the ARROW system took less than 5 minutes per tile to upload the catalogue records and check the results").

[113] *See* THE REGISTER OF COPYRIGHTS, REPORT ON ORPHAN WORKS 95 (2006); *see also* Christian L. Castle and Amy E. Mitchell, *Unhand That Orphan: Evolving Orphan Works Solutions Require New Analysis,* 27 SPG ENT. & SPORTS L. 1, 1-22 (2009).

[114] *Final Report, Digital Libraries: Recommendations and Challenges for the Future* (i2010 European Digital Libraries Initiative, High level Expert Group on Digital Libraries, Dec. 2009), *available at* http://www.dlorg.eu/uploads/External%20Publications/HLG%20Final%20Report%202009%20clean.pdf.

[115] *See* Orphan Works Directive, *supra* note 104; *see also Final Report, supra* note 114.

[116] See BRITISH SCREEN ADVISORY COUNCIL, COPYRIGHT AND ORPHAN WORKS

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'reasonable royalty' agreed upon by negotiation—or established by a third-party—rather than sue for infringement. Use of the work that has been integrated or transformed into a derivative work should be allowed to continue upon payment of a reasonable royalty and sufficient attribution. Slightly modified versions of this model have been already implemented elsewhere. For example, Canada established a compulsory licensing system based on diligent searches to use orphan works.[117] Upon showing of a serious search for the rightsholder, an administrative body can issue a non-exclusive license—limited to Canada—to use orphan works.[118]

Finally, Extended Collective Licenses (ECL) has become a policy option in several jurisdictions to tackle the orphan works problem within digitization projects.[119] They are applied in various sectors in Denmark, Finland, Norway, Sweden and Iceland[120] and included in a recent EU draft directive for the use of out-of-commerce works by cultural heritage institutions.[121] The system combines the voluntary transfer of rights from rightholders to a substantially representative collective society with the legal extension of the collective agreement to third parties who are not members of the collective society. A user may obtain a licence to use all the works included in a certain category. With the exception of the rightholders claiming individual remuneration or opting out from the system, the ECL automatically applies

(Aug. 31, 2006) (paper prepared for the Gowers Review).

[117] *See* Canadian Copyright Act, Art. 77 (Can.).

[118] *Id.*; *see* Stef van Gompel, *Unlocking the Potential of Pre-Existing Content: How to Address the Issue of Orphan Works in Europe?*, 38 INT'L REV. INTEL. PROP. COMP. L. 669, 669-702 (2007).

[119] *See* Jia Wang, *Should China Adopt an Extended Licensing System to Facilitate Collective Copyright Administration: Preliminary Thoughts*, 32 EUR. INTELL. PROP. REV. 283, 283-89 (2010); MARCO CIURCINA, JUAN CARLOS DE MARTIN, THOMAS MARGONI, FEDERICO MORANDO AND MARCO RICOLFI, CREATIVITÀ REMUNERATA, CONOSCENZA LIBERATA: FILE SHARING E LICENZE COLLETTIVE ESTESE [REMUNERATING CREATIVITY, FREEING KNOWLEDGE: FILE-SHARING AND EXTENDED COLLECTIVE LICENCES] (Mar.15, 2009) (position paper prepared for the NEXA Center for Internet and Society); JOHAN AXHAMN AND LUCIE GUIBAULT, CROSS-BORDER EXTENDED COLLECTIVE LICENSING: A SOLUTION TO ONLINE DISSEMINATION OF EUROPE'S CULTURAL HERITAGE? (Aug. 2011) (final report prepared for Europeana Connect, IViR).

[120] *See, e.g.*, Zijian Zhang, *Transplantation of an Extended Collective Licensing System-Lessons from Denmark*, 47(6) IIC 640, 640-72 (2016).

[121] *See* Proposal for a Directive of the European Parliament and of the Council on Copyright in the Digital Single Market, COM (2016) 593 final (Sept. 14, 2016), Art. 7.

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to all domestic, foreign, traceable or untraceable rightsowners. Actually—as seen also in the Google books case—courts have expressed hesitations in endorsing the ECL opt-out mechanism. In *Soulier*, the ECJ declared EU law uncompliant a French law endorsing an ECL mechanism to authorise the reproduction and digital representation of out-of-print 20th century books.[122] According to the ECJ, EU law provides authors—not collecting societies—with the right to authorise the reproduction and communication to the public of their works.[123] The *Soulier* decision might have far-reaching effects for the EU directive proposal—and more generally for all national ECL systems that might be incompatible with EU law.

V. REIMAGINING A POSITIVE PUBLIC DOMAIN

The increasing enclosure of the public domain has contributed to the crisis of acceptance in which copyright law is fallen. As Jessica Litman noted, "a vigorous public domain is a crucial buttress to the copyright system; without the public domain, it might be impossible to tolerate copyright at all."[124] The emphasis over the importance of the public domain has gained momentum together with the rise of the networked information economy. The emergence and recognition of the public domain, the development of a public domain project and the advent of cultural environmentalism coalesce also to "resist the resistance." In this respect, Daniel Drache noted that "the emergence of the public domain and public goods in the globalized society have increasingly troubled the future prospects of 'market fundamentalism.'"[125]

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[122] *See* Marc Soulier Sara Doke v Ministre de la Culture et de la Communication Premier minister, C-301/15 (ECJ, Nov. 16, 2016) (European Union); *see also* LOI n° 2012-287 du 1er mars 2012 relative à l'exploitation numérique des livres indisponibles du XXe siècle, *available at* https://www.legifrance.gouv.fr/eli/loi/2012/3/1/2012-287/jo/texte.

[123] See Council Directive 2001/29/EC on the harmonisation of certain aspects of copyright and related rights in the information society, 2001 O.J. (L 167) 10 (May 22, 2001) Art. 2(a) and 3(1).

[124] Jessica Litman, *The Public Domain*, 39 EMORY L. J. 965, 977 (1990).

[125] Daniel Drache, *Introduction: The Fundamentals of Our Time*, *in* THE MARKET OR THE PUBLIC DOMAIN: GLOBAL GOVERNANCE AND ASYMMETRY OF POWER 1 (Daniel Drache ed., Routledge 2000).

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In early copyright law, there was no positive term to affirmatively refer to the public domain, though terms like *publici juris* or *propriété publique* had been employed by 18th century jurists. [126] Nonetheless, the fact of the public domain was recognized. Soon, the idea of the public domain evolved into a "discourse of the public domain—that is, the construction of a legal language to talk about public rights in writings."[127] Historically, the term public domain was firstly employed in France by the mid-19th century—and slightly later in England and the United States—to mean the expiration of copyright.[128] Traditionally, the public domain has been defined in relation to copyright as the opposite of property, as the "other side of the coin of copyright" that "is best defined in negative terms".[129] This traditional definition regarded the public domain as a "wasteland of undeserving detritus" and did not "worry about 'threats' to this domain any more than [it] would worry about scavengers who go to garbage dumps to look for abandoned property."[130] This definitional approach has been discarded in the last thirty years.

In *Recognizing the Public Domain*—published as early as 1981—Professor David Lange departed from the traditional line of investigation of the public domain. Lange suggested that "recognition of new intellectual property interests should be offset today by equally deliberate recognition of individual rights in the public domain."[131] Lange called for an affirmative recognition of the public domain and drafted the skeleton of a new theory for the public domain. The public domain that Lange had in mind would become a "sanctuary conferring affirmative protection against the forces of private appropriation" that threatened creative expression.[132] Lange spearheaded a "conservancy mod-

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[126] *See* Jane C. Ginsburg, *"Une Chose Publique": The Author's Domain and the Public Domain in Early British, French and US Copyright Law*, 65 CAMBRIDGE L. J. 636, 638 (2006).

[127] Mark Rose, *Nine-Tenths of the Law: The English Copyright Debates and the Rhetoric of the Public Domain*, 66 LAW & CONTEMP. PROBS. 75, 77 (2003).

[128] *See* Ginsburg, *supra* note 126, at 637.

[129] William M. Krasilovsky, *Observations on Public Domain*, 14 BULL. COPYRIGHT SOC'Y 205, 205 (1967).

[130] Pamela Samuelson, *The Public Domain: Mapping the Digital Public Domain: Threats and Opportunities*, 66 LAW & CONTEMP. PROB. 147, 147 (2003).

[131] David Lange, *Recognizing the Public Domain*, 44 LAW & CONTEMP. PROBS. 147, 147 (1981).

[132] Lange, *supra* note 25, at 466.

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el", concerned with promoting the public domain and protecting it against any threats, that juxtaposed the traditional "cultural stewardship model" which regarded ownership as the prerequisite of productive management.[133]

A positive public domain propelled the "public domain project."[134] For the public domain project, enclosure of the "materials that compose our cultural heritage" is a welfare loss for society. The public domain project disregards the old metaphor describing the public domain as what is "left over after intellectual property had finished satisfying its appetite"[135] and envisions copyright as "a system designed to feed the public domain providing temporary and narrowly limited rights, [. . .] all with the ultimate goal of promoting free access."[136][137] As Professor Lange puts it, "courts have come to see the public domain not merely as an unexplored abstraction but as a field of individual rights fully as important as any of the new property rights."[138]

The legal analysis of the governance of the commons—natural resources used by many individuals in common—has inspired profoundly the modern public domain discourse.[139] Environmental and intellectual property scholars started to look at knowledge as a commons—a shared resource. In 2003, the Nobel Prize Elinor Ostrom and her colleague Charlotte Hesse discussed the applicability of their ideas on the governance of common pool resources to the new realm of the intellectual public domain.[140] The literature's application to govern-

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[133] Julie Cohen, *Copyright, Commodification, and Culture: Locating the Public Domain, in* THE FUTURE OF THE PUBLIC DOMAIN: IDENTIFYING THE COMMONS IN INFORMATION LAW 134-35 (Lucie Guibault and P. Bernt Hugenholtz eds., Kluwer Law International 2006).

[134] Michael D. Birnhack, *More or Better? Shaping the Public Domain, in* THE FUTURE OF THE PUBLIC DOMAIN, *supra* note 21, at 59, 60.

[135] *See* Lange, *supra* note 25, at 465, n. 11 (for the "feeding" metaphor).

[136] James Boyle, *The Second Enclosure Movement and the Construction of the Public Domain,* 66 LAW & CONTEMP. PROBS. 33, 60 (2003).

[137] *See* RONAN DEAZLEY, RETHINKING COPYRIGHT: HISTORY, THEORY, LANGUAGE 105 (Edward Elgar 2008).

[138] Lange, *supra note 131, at 180.*

[139] The main difference lies in the fact that a commons may be restrictive. The public domain is free of property rights and control. A commons, on the contrary, can be highly controlled, though the whole community has free access to the common resources. *See, e.g.*, Wendy J. Gordon, *Response, Discipline and Nourish: On Constructing Commons,* 95 CORNELL L. REV. 733, 736-49 (2010).

[140] *See* Charlotte Hess and Elinor Ostrom, *Ideas, Artifacts, and Facilities: Information as a Common-Pool Resource,* 66 LAW & CONTEMP. PROBS. 111, 111 (2003); *see also* Michael J. Madison, Brett M. Frischmann and Katherine J.

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ing the commons to cultural resources meant that: [t]he old dividing line in the literature on the public domain had been between the realm of property and the realm of the free. The new dividing line, drawn as a palimpsest on the old, is between the realm of individual control and the realm of distributed creation, management, and enterprise. [141]

The individual, legal, and market based control of the property regime is juxtaposed with the collective and informal controls of the well-run commons.[142] The well-run commons can avoid the tragedy of the commons without the need of single party ownership.

The environmental metaphor has propelled what can be termed as a "cultural environmentalism," [143] which in turn inspired a new politics of intellectual property.[144] The public domain is our cultural commons: it is like our air, water, and forests. As with the natural environment, the public domain—and the cultural commons that it embodies—must enjoy a "balanced and sustainable development."[145] Overreaching property theory and overly protective copyright law disrupt the delicate tension between access and protection. Unsustainable cultural development, enclosure and commodification of our cultural commons will produce cultural catastrophes. As unsustainable environmental development has polluted our air, contaminated our water, mutilated our forests, and disfigured our natural landscape, unsustainable cultural development will outrage and corrupt our cultural heritage and information landscape.

Strandburg, *Constructing Commons in the Cultural Environment*, 95 CORNELL L. REV. 657, 657 (2010); Elinor Ostrom and Charlotte Hess, *A Framework for Analyzing the Knowledge Commons*, *in* UNDERSTANDING KNOWLEDGE AS A COMMONS: FROM THEORY TO PRACTICE 41-81 (Charlotte Hess and Elinor Ostrom eds., MIT Press 2007).

[141] Boyle, *supra* note 136, at 66.

[142] *See* James Boyle, *Foreword: The Opposite of Property*, 66 LAW & CONTEMP. PROB. 1, 8 (2003).

[143] *See* James Boyle, *Cultural Environmentalism and Beyond*, 70 LAW & CONTEMP. PROB. 5, 5 (2007).

[144] *See* James Boyle, *A Politics of Intellectual Property: Environmentalism for the Net?*, 47 DUKE L. J. 87, 110 (1997).

[145] *See* Charter of Fundamental Rights of the European Union, December 18, 2000, 2000 O.J. (C364) 1, 8, 37.

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Today, many academic and civic institutions have joined this movement. [146] Civic advocacy has also been followed by several institutional variants. Recommendation 20 of the WIPO Development Agenda endorses the goal "[t]o promote norm-setting activities related to IP that support a robust public domain in WIPO's Member States."[147] Europe put together a diversified network of projects for the protection and promotion of the public domain,[148] including COMMUNIA, the European Thematic Network on the Digital Public Domain.[149] Cultural environmentalism's focus magnified on online commons and the Internet as the "über-commons—the grand infrastructure that has enabled an unprecedented new era of sharing and collective action."[150] In the last decade, we have witnessed the emergence of a "single intellectual movement, centered on the importance of the commons to information production and creativity generally, and to the digitally networked environment in particular."[151]

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[146] *See* COMMUNIA, *Survey of Existing Public Domain Competence Centers*, Deliverable No. D6.01 (Draft, Sept.30, 2009) (on file with the author).

[147] *See Development Agenda for WIPO*, www.wipo.int/ip-development/en/agenda (last visited Jan. 28, 2018); *see also* SEVERINE DUSOLLIER, SCOPING STUDY ON COPYRIGHT AND THE PUBLIC DOMAIN 69 (prepared for the Word Intellectual Property Organization) (Apr. 30, 2010).

[148] *See Europeana: Think Culture*, www.europeana.eu/portal (last visited Jan. 28, 2018); *LAPSI: Legal Aspects of Public Sector Information*, www.lapsi-project.eu (last visited Jan. 28, 2018); *DRIVER, Digital Repository Infrastructure Vision for European Research*, www.driver-repository.eu (last visited Jan. 28, 2018); *DARIAH, Digital Research Infrastructure for the Arta and the Humanities*, *available at* http://www.dariah.eu (last visited Jan. 28, 2018).

[149] *See The European Thematic Network on the Digital Public Domai n*, COMMUNIA (Jan. 28, 2018), *available at* http://communia-project.eu; THE PUBLIC DOMAIN MANIFESTO, *available at* http://publicdomainma nifesto.org/manifesto.html; *see also* GIANCARLO F. FROSIO, COMMUNIA FIN AL REPORT ON THE DIGITAL PUBLIC DOMAIN (report prepared for the Europe an Commission on behalf of the COMMUNIA Network and the NEXA Ce nter) (2012), *available at* http://communia-project.eu/final-report; Giancarl o F. Frosio, *COMMUNIA and the European Public Domain Project: A Po litics of the Public Domain*, *in* COMMUNIA, THE DIGITAL PUBLIC DOMAIN 3-4 4 (Juan Carlos De Martin and Melanie Dulong de Rosnay eds., OpenBook s Publishers, 2012).

[150] David Bollier, The Commons as New Sector of Value Creation: It's Time to Recognize and Protect the Distinctive Wealth Generated by Onlin e Commons, Remarks at the Economies of the Commons: Strategies for S ustainable Access and Creative Reuse of Images and Sounds Online Confe rence, Amsterdam (April 12, 2008) (transcripts *available at* http://www.o nthecommons.org/content.php?id=1813).

[151] YOCHAI BENKLER, THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM 10 (Yale University Press 2007)

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The modern public domain project takes over from where Kames, Jefferson, Le Chapelier, and Maculay had left it.[152] Modern and earlier advocates of the public domain reject an absolutistic rhetoric of property. This rhetoric has derailed the original civic and anti-monopolistic purpose of copyright law. Public domain's enclosure runs against the historical scope of copyright. The return of the commons, in fact, has a credible source in the history of copyright law.[153] Copyright law was meant to "encourage learning" and "promote progress" through the preservation of the "public sphere." The public domain is not "an unintended by product, or 'graveyard' of copyrighted works but its very goal."[154]

Therefore, history would suggest a paradigmatic swift that re-defines the hierarchy of priorities. Rather than a politics of intellectual property, the policy discourse should be framed in terms of a politics of the public domain. As Francis Gurry pointed out, focus should lie on "cultural policy," rather than intellectual property.[155] Any public policy of creativity should promote the idea that "information is not only or mainly a commodity; it is also a critically important resource and input to learning, culture, competition, innovation and democratic discourse."[156] The agenda of the information society cannot be dictated by commercial interests alone. Therefore, "intellectual property must find a home in a broader-based information policy, and be a servant, not a master, of the information society."[157]

As a preliminary action to turn the policy focus on the public domain and public interest, the delicate balance between private entitlements and the public domain should always be tested in advance of the enactment of any policy "by an empirical 'en-

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[152] *See* FROSIO, *supra* note 149, at 116-20.

[153] *See* Karl-Nikolaus Peifer, *The Return of the Commons - Copyright History as a Common Source*, *in* PRIVILEGE AND PROPERTY. ESSAYS ON THE HISTORY OF COPYRIGHT 348 (Ronan Deazley, Martin Kretschmer and Lionel Bently eds., Open Book Publishers 2010).

[154] Michael D. Birnhack, *More or Better? Shaping the Public Domain*, *in* THE FUTURE OF THE PUBLIC DOMAIN: IDENTIFYING THE COMMONS IN INFORMATION LAW 60 (Lucie Guibault and & P. Bernt Hugenholtz eds., Kluwer Law International 2006).

[155] *See* Gurry, *supra* note 28.

[156] Samuelson, *supra* note 130, at 171.

[157] *Id.*, at 171-72.

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vironmental impact statement' which details the effects of any proposal on the public domain and on public rights of access to cultural and scientific material."[158] Together with this preliminary action, before the recognition of any intellectual property interests, a politics of the public domain must set up the "deliberate recognition of individual rights in the public domain."[159] A politics of the public domain must provide positive protection of the public domain from appropriation and promotion of its reusability, access and preservation.[160] Several alternative or cumulative actions may then follow to shape a new politics of the public domain. As I have argued elsewhere, together with the COMMUNIA network,[161] possibly a politics of the public domain should (I) redress the many tensions with copyright protection by re-discussing term of protection, re-empowering exceptions and limitations, harmonizing relevant rules and adapting them to the technological change; (II) positively protect the public domain against misappropriation and technological protection measures; (III) propel digitization projects and conservation of human cultural heritage by solving the orphan works problem and implementing a registry system; (IV) open access to research and public sector information; (V) promote new business models to enhance creativity including alternative remuneration systems and cultural flat rate.

As David Lange said, we all are citizens of the public domain.[162] Public domain enclosure deprives citizens of their coun-

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[158] *See* Frosio, *supra* note 149, at 125-26.

[159] Lange, *supra note 131, at 147.*

[160] A now apparently deceased Brazilian copyright reform proposal used to be a statutory example of affirmative protection of the public domain, see Lei No. 9610, de 19 de Fevereiro de 1998, Atualizada com as mudanças da Minuta de Anteprojeto de Lei que está em Consulta Pública (updated with the changes to the draft law which is under public consultation) (June 12, 2010), *available at* http://www.cultura.gov.br/ consultadireitoautoral/lei-961098-consolidada. The proposal endorsed the principle that anyone who obstructs the use of works fallen in the public domain is to be subject to appropriate sanctions. *Id*., at Art. 107, I, § 1, b). The same penalties should apply to whom hinders or prevents fair or privileged uses of copyrighted works. *Id*., at Art. 107, I, § 1, a). In particular, the proposal aimed to assure that technological protection measures have time limited effects that will not surpass copyright expiration and do not impede privileged uses. Therefore, the bill allowed the circumvention of DRM technologies to make privileged uses or after copyright expiration. *Id*., at Art. 107, IV, § 2 and 3.

[161] *See* Frosio, *supra* note 149, at 125-26.

[162] Lange, *supra* note 25, at 475.

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try. Policy should nourish, protect, and promote this citizenship right. Any such policy should make, for every citizen, the public domain "a place like home, where, when you go there, they have to take you in and let you dance."[163]

VI. REIMAGINING GATEKEEPERS

Re-imagining copyright through the lens of a new paradigm that revives pre-modern into post-modern approaches to creativity does encompasses fundamentally re-imagining also the role of gatekeepers. Perhaps, here lies the true challenge where imagination must struggle the most with reality and its reactionary resistance. Mass empowerment triggers reactionary effects. Change has always unleashed a fierce resistance from the established power, both public and private. It did so with the Printing Revolution. It does now with the Internet Revolution. For public power, the emergence of limitless access, knowledge, and therefore freedom, is a destabilizing force that causes governments to face increasing accountability and therefore relinquish a share of their power. Private power sees in mass empowerment, Internet and global access to knowledge the dreadful prospective of having to switch from a top-down to a bottom-up paradigm of consumer consumption. Much to the dismay of the corporate sector, the Internet presents serious obstacles for the management of consumer behavior. As Patry noted,

> copyright owners' extreme reaction to the Internet is based on the role of the Internet in breaking the vertical monopolization business model long favored by the copyright industries [. . .] [t]he Copyright Wars are an effort to accomplish the impossible, to change the Internet into a vehicle for the greatest form of vertical monopolization ever seen . . . .[164]

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[163] *Id*., at 470.

[164] *See* WILLIAM PATRY, MORAL PANICS AND THE COPYRIGHT WARS 31-34 (Oxford U. Press 2009) (eBook Adobe Digital Editions).

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In particular, the steady enlargement of copyright becomes a tool used by reactionary forces willing to counter the Digital Revolution. From a market standpoint, stronger rights allow the private sector to enforce a top-down consumer system. The emphasis of copyright protection on a permission culture favours a unidirectional market, where the public is only a consumer, passively engaged to pay-per use or stop using copyrighted works.[165] From a political standpoint, a tight control on reuse of information will prevent mainstream culture to be challenged by alternative culture. Copyright law would serve to empower mainstream culture and marginalize minority alternative counter-culture, therefore relenting any process leading to a paradigm shift.[166]

From a broader socio-economic perspective, there is also a more systemic explanation to the reaction facing the emergence of the networked information society. Baudrillard's arguments might be useful to explain the reaction to the Digital Revolution driving cultural goods' marginal cost of distribution and reproduction close to zero.[167] Copyright law might become an instrument to protect the capitalistic notion of consumption and perpetuate a system of artificial scarcity. Insomuch the Digital Revolution turns consumers into users and then creators, it defies the very notion of consumer society. It turns the capitalistic consumer economy into a networked information economy, which is characterized by sharing and gift economy. So, for the socio-economic consumerist paradigm not to succumb, the limitless power of peer and mass collaboration must be tamed by the artificial scarcity created by copyright law. Ultimately, resistance to the Digital Revolution can be seen as a response to Baudrillard's call to a return to prodigality beyond the structural scarcity of the capitalistic market economy.[168] The Internet and

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[165] *Cf. id*, at 35.

[166] I have discussed the effects of copyright expansion on semiotic democracy—with a comprehensive review of literature on point—in a previous piece of mine to which I remand. *See* Frosio, *supra* note 11, at 376-390.

[167] For a more detailed discussion of Baudrillard's categories as applied to cyberspace and the Digital Revolution, *see* Giancarlo Frosio, *User Patronage: the Return of the Gift in the "Crowd Society"*, 2015 MICH. ST. L. REV. 1983, -1983-2046 (2015).

[168] *See* JEAN BAUDRILLARD, The Consumer Society: Myths and Structures 66-68 (SAGE Publ. 2007) (1970)

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networked peer collaboration may represent a return to "collective improvidence or prodigality" and its related "real affluence."[169] New Internet dynamics of exchange and creativity might answer in the positive Baudrillard's question whether we will "return, one day, beyond the market economy, to prodigality." [170] In Baudrillard's terms, by increasingly commodifying knowledge and expanding copyright protection, we are taming limitless power with artificial scarcity to keep in place a "dialectic of penury" and unlimited need.[171] Therefore, the reaction to the Internet revolution may be construed as a gatekeepers' attempt to keep in place their privileges as they thrive within a paradigm that builds the need of production—and overproduction—over an obsession with scarcity through the creation of artificial scarcity.

In the dedication to the *Expositiones in Summulas Petri Hispani*—printed around 1490 in Lyons—the editor, Johann Trechsel, announced: "[i]n contrast to xylography, the new art of impression I am practicing ends the career of all the scribes. They have to do the binding of the books now."[172] Similarly, in the digital era, the role of distributors might change and they might be forced to redefine their function. One of the key lessons in the gradual shift in market power in the entertainment industry these days is that the power of the old gatekeepers is declining, even as the overall industry grows. The power, instead, has definitely moved directly to the content creators themselves. Creators no

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[169] *Id*., at 67.
[170] *Id*., at 68.
[171] *Id*., at 67.
[172] Uwe Neddermeyer, *Why Were There No Riots of the Scribes? First Result of a Quantitative Analysis of the Book-production in the Century of Gutenberg*, 31 GAZETTE DU LIVRE MÉDIÉVAL 1, 7 (1997). Surprisingly, at the time of the printing revolution, the resistance to the new technology was little. Only few protests from scribes were recorded throughout Europe. *See id*., at 4-5 (reporting protests in Genoa in 1472, in Augsburg in 1473, and in Lyon in 1477); *see also* PETER BURKE, THE ITALIAN RENAISSANCE: CULTURE AND SOCIETY IN ITALY 71 (Princeton U. Press 1999) (noting the adaptability of several scribes, who became printers themselves). Reconversion from old to new jobs was smooth. A variety of new jobs was created and there are no indications of unemployment or poverty suffered by any part of society due to the introduction of the new technology. *See* Neddermeyer, at 5-7; CYPRIAN BLAGDEN, The Stationers' Company: A History, 1403-1959 23 (Stanford U. Press 1977) (reporting that "there is no evidence of unemployment or organized opposition to the new machines" in England). Quite the contrary, in the last quarter of the fifteenth century more money was spent on books that any time before. *Id*.

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longer need to go through a very limited number of gatekeepers, who often provide deal terms that significantly limit the creator's ability to make a living. Instead, a major new opportunity has opened up, not for gatekeepers, but for organizations that enable artists to do the different things that the former gatekeeper used to do—but while retaining much more control, as well as a more direct connection with fans. As discuss at length in another piece of mine,[173] there have been emerging multiple organizations enabling a direct discourse between artists and users, such as Kickstarter, TopSpin or Bandcamp.[174] As a consequence, traditional cultural intermediaries might be forced to give up their *Ancien Régime*'s privileges, thus causing further resistance to change. In the words of Nellie Kroes, European Commission Vice-President for the Digital Agenda,[a]ll revolutions reveal, in a new and less favourable light, the privileges of the gatekeepers of the "Ancien Régime". It is no different in the case of the Internet revolution, which is unveiling the unsustainable position of certain content gatekeepers and intermediaries. No historically entrenched position guarantees the survival of any cultural intermediary. Like it or not, content gatekeepers risk being sidelined if they do not adapt to the needs of both creators and consumers of cultural goods. […] Today our fragmented copyright system is ill adapted to the real essence of art, which has no frontiers. Instead, that system has ended up giving a more prominent role to intermediaries than to artists. It irritates the public who often cannot access what artists want to offer and leaves a vacuum, which is served by illegal content, depriving the artists of their well-deserved remuneration. And copyright enforcement is often entangled in sensitive questions about privacy, data protection or even net neutrality. […] It may suit some vested interests to avoid a debate, or to frame the debate on copyright in moralistic terms that merely demonise millions of citizens. But that is not a sustainable approach. […] My position

[173] *See* Frosio, *supra* note 167, at 2039-46.

[174] *See* MICHAEL MASNICK AND MICHAEL HO, THE SKY IS RISING: A DETAILED LOOK AT THE STATE OF THE ENTERTAINMENT INDUSTRY 5-6 (Floor 64, Jan. 2012), *available at* http://www.techdirt.com/skyisrising.

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is that we must look beyond national and corporatist self-interest to establish a new approach to copyright.[175]

VII. REIMAGINING COPYRIGHT ALTERNATIVE BUSINESS MODELS

Neelie Kroes stressed that copyright fundamentalism has prejudiced our capacity to explore new models in the digital age:

> So new ideas which could benefit artists are killed before they can show their merit, dead on arrival. This needs to change. [. . .]. So that's my answer: it's not all about copyright. It is certainly important, but we need to stop obsessing about that. The life of an artist is tough: the crisis has made it tougher. Let's get back to basics, and deliver a system of recognition and reward that puts artists and creators at its heart.[176]

This crisis of the notion of copyright propelled proposals for reform tackled the uneasy coexistence between copyright, digitization and the networked information economy. They attempt to fix copyright to promote creativity within the emerging cumulative, collaborative and open access norms of the information society.

In search of alternative remuneration systems, researchers, activists, consumer organizations, artist groups, and policy makers have proposed to finance creativity on a flat-rate base.[177] In the past, levies on recording devices and media have been set up upon the acknowledgment that private copying cannot be

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[175] Neelie Kroes, European Commission Vice-President for the Digital Agenda, A Digital World of Opportunities, Speech at the Forum d'Avignon - Les Rencontres Internationales de la Culture, de l'Économie et des Medias, Avignon, France, SPEECH/10/619 (Nov. 5, 2010).

[176] Neelie Kroes, Who Feeds the Artist?, Speech at the Forum d'Avignon - Les Rencontres Internationales de la Culture, de l'Économie et des Medias, Avignon, France, SPEECH/11/777 (Nov. 19, 2011), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH%2F11%2F777.

[177] Volker Grassmuck, *The World is Going Flat(-Rate): A Study Showing Copyright Exception for Legalizing File-Shearing Feasible as a Cease-Fire in the "War on Copyright" Emerges*, INTELLECTUAL PROPERTY WATCH, (May 11, 2009), *available at* http://www.ip-watch.org/weblog/2009/05/11/the-world-is-going-flat-rate.

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prevented.[178] The same reasoning would apply to the introduction of a legal permission to copy and make available copyrighted works by individuals for non-commercial purposes in the Internet.[179] Flat rate proposals would favour a sharing ecology that is best suited to the networked information economy.

A study of the Institute of European Media Law (EML) has argued that this may be "nothing less than the logical consequence of the technical revolution introduced by the internet."[180] This study also described the minimum requirements for a cultural flat-rate as follows: (i) a legal licence permitting private individuals to exchange copyright works for non-commercial purposes; (ii) a levy, possibly collected by the ISPs, flat, possibly differentiated by access speed; and (iii) a collective management, i.e. a mechanism for collecting the money and distributing it fairly.[181] On the basis of the EML study, the German and European Green Parties included in their policy agenda the promotion of a cultural flat rate to decriminalise P2P users, remunerate creativity and relieve the judicial system and the ISPs from mass-scale prosecution. The EML study found that a levy on Internet usage legalising non-commercial online exchanges of creative works conforms with German and European copyright law, even though it requires changes in both.[182]

Several other flat-rate models have been proposed.[183] A non-commercial use levy permitting non-commercial file sharing

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[178] In the analog environment, many national legislations implemented quasi flat rate models and different arrangements of private copying levies that may be envisioned as a form of cultural tax. Private copying levies are special taxes, which are charged on purchases of recordable media and copying devices and then redistributed to the right holders by means of collecting societies. *See, e.g.*, MARTIN KRETSCHMER, PRIVATE COPYING AND FAIR COMPENSATION: AN EMPIRICAL STUDY OF COPYRIGHT LEVIES IN EUROPE (Oct. 2011) (report prepared for the UK Intellectual Property Office).

[179] *See* HUGENHOLTZ, BERNT, LUCIE GUIBAULT AND SJOERD VAN GEFFEN, THE FUTURE OF LEVIES IN A DIGITAL ENVIRONMENT (Institute for Information Law 2003).

[180] INSTITUT FÜR EUROPÄISCHES MEDIENRECHT [INSTITUTE OF EUROPEAN MEDIA LAW] (EML), DIE ZULÄSSIGKEIT EINER KULTURFLATRATE NACH NATIONALEM UND EUROPÄISCHEM RECHT [THE ADMISSIBILITY OF A CULTURAL FLAT RATE UNDER NATIONAL AND EUROPEAN LAW] 63 (Mar. 13, 2009) (study prepared for the German and European Green Party).

[181] *Id.*

[182] *Id.*

[183] *See* ALAIN MODOT, HÉLOÏSE FONTANEL, NIC GARNETT, ERIK LAMBERT, ANDRÉ CHAUBEAU, JÉRÔME CHUNG AND PIERRE JALLADEAU, THE "CONTENT

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of any digitised work was firstly proposed by Professor Neil Netanel.[184] Such levy would be imposed on the sale of any consumer electronic devices used to copy, store, send or perform shared and downloaded files but also on the sale of internet access and p2p software and services. An *ad hoc* body would be in charge of determining the amount of the levy. The proceeds would be distributed to copyright holders by taking into consideration the popularity of the works to be measured by tracking and monitoring technologies. Users could freely copy, circulate and make non-commercial use of any works that the right holder has made available on the Internet. William Fisher followed up on Netanel with a more refined and comprehensive proposal.[185] Creators' remuneration would still be collected through levies on media devices and Internet connection. In Fisher's system, however, a governmentally administered registrar for digital content, or alternatively a private organization, would be in charge of the management of creative works in the digital environment. Digitised works would be registered with the Registrar and embedded with digital watermarks. Tracking technologies would measure the popularity of the works circulating online. The Registrar would then redistribute the proceedings to the registered right holders according to popularity of the works.

Again, Philippe Aigrain proposed a "creative contribution" encompassing a global licence to share published digital works in the form of extended collective licensing, or, absent an agreement, of legal licensing.[186] Remuneration would be provided by a flat-rate contribution that will be paid by all Internet subscribers. Half of the money collected would be used for the remuneration of works that have been shared over the Internet according to their popularity. Measurement of popularity would be based on a large panel of voluntary Internet users

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FLAT-RATE": A SOLUTION TO ILLEGAL FILE-SHARING? STUDY (July 2011) (study prepared for the European Parliament).

[184] Netanel Neil W., *Impose A Noncommercial Use Levy to Allow Free Peer-To-Peer File Sharing*, 17 HARV. J. L. & TECH. 1, 1-84 (2003).

[185] *See* WILLIAM W. FISHER, PROMISES TO KEEP: TECHNOLOGY, LAW AND THE FUTURE OF ENTERTAINMENT 199-259 (Stanford Law and Politics 2004).

[186] *See* PHILIPPE AIGRAIN (WITH CONTRIBUTION OF SUZANNE AIGRAIN), SHARING: CULTURE AND THE ECONOMY IN THE INTERNET AGE 59-137 (Amsterdam University Press 2012).

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transmitting anonymous data on their usage to collective management societies. The other half of the money collected would be devoted to funding the production of new works and the promotion of added-value intermediaries in the creative environment.

Proposals to apply ECL to legitimize file-sharing have been also advanced. Collective management bodies would negotiate the license with users' associations or internet service providers. In exchange for the right of reproducing and making available content online, rights holders will be remunerated by the proceedings collected through the extended collective license. A related proposal would place the right to make available to the public under mandatory collective management.[187] According to this proposal, to enjoy the economic rights attached to the right of making available to the public, rights holders would be obligated to use collective management. As a consequence, the ISPs would pay a lump-sum fee or levy to the collective societies in exchange for the authorization to download and make the collective society's entire repertoire available to users. The money collected would be then redistributed to the right holders.

More radically, future support for creativity may increasingly derive directly from the public. Crowd-funding and the ubiquity of digital networks may facilitate the emergence of a patronage model for creativity, in which the public might provide unfiltered and direct economic support to creativity. [188] Experiments with pay-as-you-wish pricing in the music industry reveal that fans will voluntarily pay far more for their favorite

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[187] *See* SILKE VON LEWINSKI, MANDATORY COLLECTIVE ADMINISTRATION OF E XCLUSIVE RIGHTS-A CASE STUDY ON ITS COMPATIBILITY WITH INTERNATIONAL AN D EC COPYRIGHT LAW (UNESCO e-Copyright Bulletin, Jan.-Mar. 2004), *ava ilable at* http://portal.unesco.org/culture/en/files/19552/11515904771 svl_e. pdf/svl_e.pdf (discussing a proposed amendment in the Hungarian Copyri ght Act). *See* CARINE BERNAULT AND AUDREY LEBOIS UNDER THE SUPERVISION OF PROFESSOR ANDRE LUCAS, PEER-TO-PEER ET PROPRIETE LITTERAIRE ET ARTISTI QUE ETUDE DE FAISABILITE SUR UN SYSTEME DE COMPENSATION POUR L'ECHANGE DES ŒUVRES SUR INTERNET [PEER-TO-PEER FILE SHARING AND LITERARY AND AR TISTIC PROPERTY. A FEASIBILITY STUDY REGARDING A SYSTEM OF COMPENSATION FOR THE EXCHANGE OF WORKS VIA THE INTERNET] (June 2005) (study prepar ed for ADAMI and SPEDIDAM) (with the same proposal endorsed by the French Alliance Public-Artistes, campaigning for the implementation of a Licence Globale).

[188] For a full discussion of the idea of user patronage-and a review of the economics of creativity form a historical perspective, *see* Frosio, *supra* note 167.

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music than economic models would ever predict.[189] For example, Bandcamp—a platform that lets musicians set up simple content stores for their works and allows for streams, pay-what-you-want, free or conditional downloads—helped artists to make over one million dollars a month. Bandcamp states that when given the option of paying-what-you-want for albums with a suggested price, fans pay an average of fifty percent more than the minimum price.[190] The data suggest that artists have increasingly valuable opportunities to go directly to fans, rather than surrendering revenue streams to gatekeepers. Consumers are often willing to spend more if they feel that they are really getting something of value and there is a direct connection to the artist. In this sense, TopSpin Media—a company providing tools to content creators to allow them to promote a direct-to-fan marketing and retail—is another interesting example. According to TopSpin Media, the average transaction price increased from $22 to $26 over a year, with a pick of $88 for offers including a ticket for a live event.[191]

The ubiquitous power of Internet networks has made possible a direct connection between artists and the public to support the creative process in innovative ways.[192] In particular, digital crowd funding is an increasingly popular tool to raise money online.[193] On Kickstarter and similar platforms, people can pledge for an economic goal, which is set up in advance by the project developer. Kickstarter works by giving artists a way to

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[189] *See* YOCHAI BENKLER, THE PENGUIN AND THE LEVIATHAN: HOW COOPERATION TRIUMPHS OVER SELF-INTEREST 147-49 (Crown Business 2011); *see also* CHRIS ANDERSON, FREE: THE FUTURE OF A RADICAL PRICE (Hyperion Books 2009); CHRIS ANDERSON, THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS FOR MORE (Hyperion Books 2006).

[190] *See* BANDCAMP, www.bandcamp.com.

[191] *See* TOPSPIN MEDIA, http://www.topspinmedia.com (last visited Jan. 29,2018); *see also* MASNICK AND HO, *supra* note 174, at 5.

[192] *See* Michael Carrier, *No, RIAA, It's Not the End of the World for Musicians*, 83(2) UMKC L. Rev 287, 287-302 (2014) (showing how technology has made it easier for musicians to participate in every step of the process: creation (GarageBand), distribution (Twitter, YouTube), marketing (Topspin, Bandcamp), royalty collection (CD Baby Pro, TuneCore), crowdfunding (Kickstarter, Indiegogo), and touring (Songkick, Bandsintown); this in turn has made easier for musicians to forge stronger connections with fans).

[193] For a general overview of crowdfunding and literature review, see Moritz, Alexandra and Jorn H. Block, *Crowdfunding: A Literature Review and Research Directions*, *in* CROWDFUNDING IN EUROPE: STATE OF THE ART IN THEORY AND PRACTICE 25-53 (Dennis Brüntje and Oliver Gajda eds., Springer 2015).

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let fans crowdfund the creation of new works. It lets artists offer different tiers, through which fans can help fund a project, in the hope of reaching a funding threshold. Only after the threshold is met does the money change hands. As of September 2015, almost two billion dollars have been pledged to artists through Kickstarter.[194] There are 253,937 launched projects with a success rate of 37.05 percent. Kickstarter's stats also report that 91,931 projects were successfully funded and approximately 1.66 billion dollars made to successful projects. Kickstarter's successful stories have become countless. Kickstarter funds all sorts of creative works, and so far, almost $400 million was pledged to games, almost $300 million was pledged to film and video, over $154 million pledged to music, and nearly $80 million pledged to publishing.

Of course, Kickstarter is just one of a number of similar platforms, such as ArtistShare, SellaBand, IndieGoGo, PledgeMusic, AfricaUnsigned, MyMajorCompany, Mobcaster, TubeStart, Pozible, Wishberry, CentUp, Crowdfunder, or Ulule.[195] These services may apply an "all or nothing" or a "keep it all" model. In the latter case, the funds collected are handed over to the campaigner, regardless of whether the project goal is met or not. Other crowdfunding platforms, such as Bountysource, Patreon, or Sprked, allow for a continuous funding model, rather than one-time donation, for those creators making content on a regular basis.[196] There are also services allowing users to award creators after the works have been published. Flattr, for example, is a microdonation application that displays this information alongside the content.[197] An internet user would

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[194] *See Stats*, KICKSTARTER, https://www.kickstarter.com/help/stats.

[195] *See* ARTISTSHARE, www.artistshare.com (music); SELLABAND, www.sellaband.com (music); INDIEGOGO, www.indiegogo.com (miscellaneous); PLEDGEMUSIC, www.pledgemusic.com (music); AFRICAUNSIGNED, www.africaun signed.com (music); MYMAJORCOMPANY, www.mymajorcompany. com (film & video); MOBCASTER, http://mobcaster.com (TV shows); TUBESTART, www.tubestart.com (YouTube video Creator); POZIBLE, www.pozible.com (creative projects); WISHBERRY, www.wishberry.in (creative projects); CENTUP, www.centup.org (blogger, podcasters, web-based publishers); CROWDFUNDER, www.crowdfunder.co.uk (miscellaneous); ULULE, www.ulule.com (miscellaneous).

[196] *See* BOUNTYSOURCE, www.bountysource.com (open-source software); PATREON, www.patreon.com (music, podcasts, vloggers, YouTube videos, webcomics); SPRKED, https://sprked.com (gaming content).

[197] *See* FLATTR, https://flattr.com.

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give between 2 and 100 euros per month and could then nominate works that they wish to reward or "flattr," a play on the words "flatter" and "flat-rate".[198]

VIII. CONCLUSIONS: RE-IMAGINING CREATIVITY FROM COMMON ROOTS

The notion of creativity in the East and West—as well as Global North and Global South—shares common roots. For millennia, it was based on openness, participation and inclusiveness, rather than exclusive rights. From Confucius to Plato—and the tradition they shaped for very long time—originality, imitation, and borrowing coexisted as part of a collective, cumulative and collaborative creative model. Creative paradigms departed at about the time of the Enlightenment when the Western perception of creativity took a more markedly individualistic direction. This has led to over-propertization of intellectual entitlements. In time, this Western model—especially after TRIPs—has been exported internationally. At least, this has been the plan on the agenda for quite some time now. In truth, he assimilation into the Western creative model runs counter to the desire of the Global South to reclaim cultural identity from imperial power. Rather than concluding that "resistance is futile," the non-Western world should be guided by the idea that "[a]assimilation in an unworthy society is an unworthy goal."[199] Johanna Gibson talks about a grand plan of intellectual property and interpretation of knowledge in modern Western societies and contrasts it with other social arrangements. Gibson noted:

> The self-esteem and social worth derived from propertied success in the western world, is incompatible with the principles of individual subjectivity premised upon community in traditional and Indigenous communal philosophies, where "the individual feels socially worthy and important because his or her role and activity in the community are appreciated. The system affords the individual the opportunity to make

[198] *Id*.
[199] MARILYN FRENCH, BEYOND POWER 474 (1985).

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> a meaningful life through his or her contribution to general welfare."[200]

A global movement has emerged challenging the Western intellectual property model, its over-expansive propertarian emphasis, its apparent inconsistencies with technological innovation and the transformation in the creative economics it has brought about. Building upon it vision—I'd like to sketch out a roadmap for reform that reconnects Eastern and Western creative experience in light of a common past, looking for a shared future. This roadmap would like to reshape the interplay between community, law, and market to envision a system that may fully exploit the digital opportunity by looking at history of creativity as a guidance.[201]

The roadmap for reform I envision would emphasize the role of the users, the necessity to rethink users' rights, and users' involvement in the legislative process. So far, users have had very limited access to the bargaining table when copyright policies had to be enacted. This is due to the dominant mechanics of lobbying that largely excluded users from any policy decisions. This led to the implementation of a copyright system that is strongly protectionist and pro-distributors. Further, in the networked, peer and mass productive environment, creativity seeks a politics of inclusive rights, rather than exclusive. This is a paradigmatic swift that would re-define the hierarchy of priorities by thinking in terms of "cultural policy" and developing a politics of access and politics of the public domain, rather than a politics of intellectual property. Before the recognition of any intellectual property interests, a politics of the public domain must set up the "deliberate recognition of individual rights in the public domain"

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[200] JOHANNA GIBSON, COMMUNITY RESOURCES: INTELLECTUAL PROPERTY, INTERNATIONAL TRADE AND PROTECTION OF TRADITIONAL KNOWLEDGE 73 (Ashgate 2005) *citing* KWAME GYEKYE, AN ESSAY ON AFRICAN PHILOSOPHICAL THOUGHT: THE AKAN CONCEPTUAL SCHEME (Temple U. Press 1995).

[201] Individual components of this roadmap for reform have been described in previous works of mine-to, which I refer in this article. A more detailed review of this roadmap for reform-with each component of the proposal acting as a pillar for a metaphorical temple dedicated to the enhancement of creativity-will be the subject of Chapter 10, *The Temple of Digital Enlightenment*, of my forthcoming book RECONCILING COPYRIGHT WITH CUMULATIVE CREATIVITY: THE 3RD PARADIGM (Edward Elgar 2018).

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and positively protect it from appropriation.[202] Again, a politics of inclusive rights, access, and the public domain seek the demise of copyright exclusivity to reconnect the creative process with its traditional cumulative and collaborative nature.[203] In turn, additional mechanisms should provide economic incentive to creation, such as a liability rule integrated into the system or an apportionment of profits. A politics of inclusivity would de-construe the post-romantic paradigm over-emphasizing creative individualism and absolute originality and adapt to networked and user-generated creativity. Finally, alternative compensation systems will gradually substitute traditional copyright business models. Perhaps, in the future, the transition to a consumer gift system or user patronage, through digital crowd-funding, would make support for creativity increasingly derive from a direct and unfiltered discourse between authors and the public.

Reimagining copyright to make it fit to the digital environment does entail reimagining users' rights, policy approaches, copyright exclusivity and copyright business models. Given emerging new economics and social perception of creativity online, modern copyright policies should be reimagined through lens magnifying on access and a positive notion of the public domain. Copyright exclusivity should be also reimagined by crafting within the system a new incentive formula, communitarian rather than individualistic, inclusive rather than exclusive, which might propel creativity though the power of imitation. Inclusivity might help reimagining gatekeepers and business models for creativity to be newly designed around gift economy approaches, crowd funding and user-author interactions. The power of imitation reaches far from the Confucian-Platonic tradition into modern digital creative practices based on remix and communitarian reactions. It should be given again a leading

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[202] *See*, for further discussion of a politics of the public domain, Frosio, *supra* note 149.

[203] This proposal-and the historical interdisciplinary research that serves as a background—has been discussed at length in previous works of mine to which I refer. *See* Frosio, *supra* note 11; Giancarlo F. Frosio, *A History of Aesthetics from Homer to Digital Mash-ups: Cumulative Creativity and the Demise of Copyright Exclusivity*, 9 LAW AND HUMANITIES 262, 262-96 (2015), *available at* http://www.tandfonline. com/doi/full/10.1080/17521483.2015.1093300.

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role in modern policies for creativity, reconciling pre-modern, modern and post-modern approaches to creativity, copyright and cumulative creativity, and Western and Eastern visions.

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Commentary on Article 52(5) of Contract Law of the People's Republic of China

ZHU Qingyu[*]

ABSTRACT

According to Article 52(5) of Contract Law of the People's Republic of China, a contract shall be void if it violates the mandatory provisions of laws and administrative regulations. Article 4 of the Interpretation I of the Supreme People's Court on Several Issues concerning the Application of the PRC Contract Law explicitly limits the legal authorities invalidating a contract to (a) the laws enacted by the National People's Congress and its Standing Committee, and (b) the administrative regulations formulated by the State Council, excluding local regulations or departmental rules. Moreover, Article 14 of the Interpretation II of the Supreme People's Court on Several Issues concerning the Application of the PRC Contract Law further confines the term "mandatory provisions" as mentioned in Article 52(5) of the Contract Law to "mandatory provisions on effectiveness". Likewise, Articles 15 and 16 of the Guiding Opinions of the Supreme People's Court on Several Issues concerning the Trial of Cases of Disputes over Civil and Commercial Contracts in the Current Situation draws a distinction between mandatory provisions on effectiveness and mandatory provisions on administration. This Article suggests that (a) it is questionable to limit the hierarchy of legal authorities invalidating a contract, and (b) the dichotomy between mandatory provisions on effectiveness and mandatory provisions on administration also creates confusions in terms of the concepts, criteria, and judicial practice; (c) the key in properly applying Article 52(5) of the Contract Law is to explore the legislative intent.

[*] ZHU Qingyu, Professor of Law, Zhejiang University Guanghua Law School. This translation was produced by ZHENG Xinjia, YUAN Ziyan, DENG Qicheng, REN Yuewei and MA Jialin from Peking University School of Translation Law.

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Key words: *Hierarchy of Legal Authorities, Mandatory Provisions on Effectiveness, Mandatory Provisions on Administration, Legislative Intent.*

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I. LEGISLATIVE INTENT AND FUNCTION

(1) The maintenance of a societal community is based on the premise that its mandatory order has to be complied with. Such mandatory order exists outside the field of private autonomy, so it cannot be changed by individual's intention. Therefore, if a juristic act conflicts with the mandatory order, it is likely to be void. Article 52(5) of Contract Law of the People's Republic of China (hereinafter referred as " Article 52(5)") intends to regulate the juristic acts that violate the mandatory order.

(2) Article 52(5) only mentions the legal effect, namely, a contract shall be void if it violates the mandatory provisions, but it does not elaborate what is the constitutive element. Thus, it cannot be cited as a basis of adjudication alone[1]. In this sense, Article 52(5) is just a specific legal provision but cannot function as an independent legal basis[2].

(3) Although as an incomplete provision that fails to elaborate its constitutive elements, the purpose of Article 52(5) is not to be a complete provision with supplement from other private law provisions. Rather, it introduces the prohibitive rules in other laws, especially the public law and criminal law, into the private law by referring to such prohibitive rules[3]. Considering this, Professor Su Yongqin points out, Article 52(5) is not a general referral provision, but a referral provision with a specific function: it introduces prohibitive rules in public law into private law, thus harmonizing public regulation and private autonomy.[4]

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[1] However, there are still some courts only citing Article 52(5) of Contract Law as the basis of adjudication, like the case of artist village which has received wide attention. 马海涛与李玉兰房屋买卖合同纠纷上诉案[Ma Haitao v. Li Yulan on Appeal Dispute over Sale of House Contract] (2007)通民初字第 1031 号, (Beijing Tongzhou District People's Ct. Jul., 2007) CLI.C.1761585 CHINALAWINFO; 马海涛与李玉兰房屋买卖合同纠纷上诉案[Ma Haitao v. Li Yulan on Appeal Disputes over Sale of House Contract] (2007)二中民终字第 13692 号, (Beijing Second Interm. People's Ct. Dec. 17, 2007) CLI.C.1761585 CHINALAWINFO.

[2] Vgl. Christian Armbrüster, Kommentar zum § 138, in: *Münchener Kommentar zum BGB*, 5. Aufl., München: C. H. Beck, 2006, Rn. 4.

[3] *See* 沈德咏 (SHEN DEYONG) & 奚晓明 (XI XIAOMING), 最高人民法院关于合同法司法解释(二)理解与适用 [UNDERSTANDING AND INTERPRETATION OF INTERPRETATION (II) OF THE SUPREME PEOPLE'S COURT ON CERTAIN ISSUES CONCERNING THE APPLICATION OF THE PRC CONTRACT LAW], at 107 (2009).

[4] See 苏永钦 (Su Yongqin), 以公法规范控制私法契约——两岸转介条款的比较与操作建议 [*Private Contracts under the Control of Public Laws: Compar-*

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II. LEGAL AUTHORITIES

A. Hierarchy of Legal Authorities

(4) Article 52(5) of PRC Contract Law derives from the one scenario listed in Article 58.1(5) under General Provisions on the Civil Law of the People's Republic of China (hereinafter referred as "Article 58.1(5)"), which provides that a civil juristic act shall not violate law or the public interest. Literally, Article 58.1(5) seems to take the view that the violation of any law will invalidate a juristic act. This interpretation is too broad because not all of the legal rules are mandatory rules and cannot be violated. Legal rules can be classified into default rules and mandatory rules based on whether it is binding on parties. Default rules can be modified or overridden by parties, so default rules are not covered in Article 58.1(5). Mandatory rules represent the mandatory order in a country and must be enforced. More precisely, mandatory rules can be further classified into imperative rules (mandates) and prohibitive rules (injunctions). The former category compels the parties to actively engage in a certain act while the latter category forbids the parties to do something. Nearly all of the mandatory rules in private law are prohibitive rules since private autonomy is an essential characteristic of private law and absence of legal prohibition means freedom[5]. For this reason, a juristic act violates mandatory order under Article 52(5) actually means that it violates a prohibitive rule.

(5) Article 52(5) of Contract Law narrows the scope of "law" in Article 58.1(5) of General Provisions on the Civil Law (hereinafter referred as "General Provisions"). It provides that a contract shall be void only if "it violates the mandatory provisions of the laws or administrative regulations". Article 52(5) is further narrowed in two aspects: first, default rules are excluded; second, the legal authorities which can invalidate a contract are limited to the laws enacted by the National People's Congress

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ing Switch-over Clauses in Civil Laws across Taiwan Strait and some Remarks on Their Application], 人大法律评论 [RENMIN UNIVERSITY LAW REVIEW], at 20–21 (2010).

[5] *See* 朱庆育(Zhu Qingyu), 私法自治与民法规范——凯尔森规范理论的修正性运用 [*Private Autonomy and Civil Law: Modified Application of Hans Kelsen's Theory*], 中外法学 [PEKING UNIVERSITY LAW JOURNAL], issue 3, at 466 and the following pages (2012).

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and its Standing Committee[6], and the administrative regulations formulated by the State Council[7], excluding local regulations, departmental rules[8] or other regulations and rules in a board sense[9].

(6) Besides, the interpretations issued by the Supreme People's Court can always be cited as the basis of adjudication. In Provisions of the Supreme People's Court on the Citation of Laws, Regulations and Other Normative Legal Documents in Adjudicative Documents (hereinafter referred as "Provisions on Citation in Adjudicative Documents"), judicial interpretations are listed together with laws and legal interpretations, which are characterized as "shall be" cited by civil adjudicative documents. However, administrative regulations are listed together with local regulations, autonomous regulations and separate regulations, which are characterized as "may be" cited[10]. As for State Council departmental rules, local departmental rules or other normative legal documents, the court has discretion to determine their legality and validity before citing them as the basis of reasoning[11].

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[6] 立法法 [Law on Legislation] (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000) chapter II, CLI.1.26942 CHINALAWINFO.

[7] *Id.* Chapter III.

[8] *Id.* Chapter IV.

[9] 最高人民法院关于适用《中华人民共和国合同法》若干问题的解释（一）[Interpretation (I) of the Supreme People's Court on Certain Issues concerning the Application of the PRC Contract Law] (promulgated by the Sup. People's Ct., Dec. 19, 1999, effective Dec. 19, 1999) art. 4, CLI.3.23702 CHINALAWINFO; 崂山国土局与南太置业公司国有土地使用权出让合同纠纷案[Land Bureau of Mount Lao v. Nantai Real Estate Co. on Contract Dispute of State-Owned Land Use Right Transfer] (2004)民一终字第 106 号, (Sup. People's Ct. Dec. 22, 2005) CLI.C.80392 CHINALAWINFO; 西安市商业银行与健桥证券股份有限公司、西部信用担保有限公司借款担保合同纠纷案 [Xi'an Commercial Bank v. Capital-Bridge Securities Joint Stock Co., Ltd., West Credit Guaranty Co., Ltd. on Loan Guarantee Contract Dispute] (2005)民二终字第 150 号, (Sup. People's Ct. Sept. 27, 2005) CLI.C.67450 CHINALAWINFO; 海南康力元药业有限公司、海南通用康力制药有限公司与海口奇力制药股份有限公司技术转让合同纠纷申请再审案 [Hainan Kangliyuan Pharmaceutical Co., Ltd., Hainan General Kangli Pharmaceutical Co., Ltd. v. Haikou Qili Pharmaceutical Co., Ltd. on Retrial Dispute over Technology Transfer Contract] (2011)民提字第 307 号, (Sup. People's Ct. Dec. 9, 2011) CLI.C.1336668 CHINALAWINFO.

[10] 最高人民法院关于裁判文书引用法律、法规等规范性法律文件的规定 [Provisions of the Supreme People's Court on the Citation of Laws, Regulations and Other Normative Legal Documents in Adjudicative Documents](promulgated by the Sup. People's Ct., Oct. 26, 2009, effective Nov. 4, 2009) art. 4, CLI.3.23702 CHINALAWINFO.

[11] *Id.* art. 6.

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(7) In spite of this, some courts still cited State Council departmental rules[12] or local departmental rules[13] as the basis of adjudication to invalidate contracts upon the enforcement of the Contract Law. Moreover, one trial court even ruled that violation of a company's articles of association equals to a violation of law, thus citing Article 58.1(5) of General Provisions invalidates the contract[14]. But the reasoning of the judgment has been changed by the intermediate court[15].

(8) Apparently, Article 52(5) of Contract Law, Article 4 of Contract Interpretation Part I and Provisions on Citation in Adjudicative Documents all intend to enhance the hierarchy of legal authorities that can invalidate contracts. By contrast, the word "law" in Article 134 of German Civil Code (Bürgerliches Gesetzbuch) has a different meaning, which not only refers to all formal legal documents at either Federal or State level[16], but also goes beyond the scope of statutory law and includes customary law[17]. Enhancing the hierarchy of legal authorities aims to prevent excessive administrative control from invalidating too many contracts[18]. The reason behind is that there is no judicial review

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[12] 李新永与南阳市地方海事局房屋买卖合同案［Li Xinyong v. Nanyang MSA on Dispute over Sale of House Contract］(2008)南召民商初字第 84 号, (Nanzhao County People's Ct. Jul. 25, 2010) CLI.C.683821 CHINALAWINFO; 山西汾西新峪煤业有限责任公司与中泽建工集团有限责任公司建设工程合同纠纷上诉案 [Shanxi Fenxi Xinyu Coal Industry Co., Ltd. v. Zhongze Construction Group Co., Ltd. on Appeal Dispute over Construction Project Contract] (2014) 晋民终字第 62 号, (Shanxi High People's Ct. Aug. 7, 2014) CLI.C.3788953 CHINALAWINFO.

[13] 厦门升汇国际贸易控股有限公司诉厦门奔马实业总公司企业出售合同案 [Xiamen Shenghui International Trade Holding Co., Ltd. v. Xiamen Benma Industrial Co., Ltd. on Dispute over Sale of Enterprise Contract] (2004) 厦民终字第 696 号, (Fujian Province Xiamen Interm. People's Ct. May 12, 2004) CLI.C.49203 CHINALAWINFO.

[14] 苏州市金三角家具商场诉苏州工业园区清源环保运营工程有限公司、张杏弟股权转让案[Suzhou Jinsanjiao Furniture Mall v. Suzhou Industrial Park Qingyuan Environmental Construction Co., Ltd., Zhang Xingdi on Dispute over Equity Transfer] (2002)金民二初字第 097 号, (Jiangsu Province Suzhou Jinchang District People's Ct. May 27, 2002) CLI.C.45556 CHINALAWINFO.

[15] 苏州市金三角家具商场诉苏州工业园区清源环保运营工程有限公司、张杏弟股权转让案[Suzhou Jinsanjiao Furniture Mall v. Suzhou Industrial Park Qingyuan Environmental Construction Co., Ltd., Zhang Xingdi on Equity Transfer] (2002)苏中民二终字第 348 号, (Jiangsu Province Suzhou Interm. People's Ct. Oct. 9, 2002) CLI.C.45556 CHINALAWINFO.

[16] Vgl. Christian Armbrüster, Kommentar zum § 134, in: *Münchener Kommentar zum BGB*, 5. Aufl., München: C. H. Beck, 2006, Rn. 30.

[17] *See supra* note 16, at Rn. 32.

[18] *See* 王利明 (Wang Liming), 论无效合同的判断标准 [*Criteria for Invalid*

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in China and courts possess no power to declare the illegality of normative legal documents[19]. However, local regulations, autonomous regulations and separate regulations are listed forward together with administrative regulations, which may be cited directly in civil adjudicative documents, pursuant to Article 4 of Provisions on Citation in Adjudicative Documents. Thus, the legal authorities which can invalidate a contract under Article 52(5) are expanded indirectly. In this regard, when combining Article 4 with Article 6 of Provisions on Citation in Adjudicative Documents, courts in China are actually empowering themselves to review the legality of normative legal documents.

(9) It cannot be doubted that expansion of administrative control deserves our concern. However, enhancing the hierarchy of legal authorities to limit administrative control is using another mistake to correct one preexisting mistake. Instead of leading to a good result, this would establish bad practices, which are difficult to get rid of in the end.

The main difference between criminal law, public law and private law (civil law) lies in the scope of legal sources. Both criminal law and public law have a limited source while private law has a relatively open source. Under the basic principle that "no punishment should be given if the law has not clearly stipulated the penalty for the crimes (*Nulla poena sine lege*)"[20], there is almost no other legal source in criminal law except for the law enacted by the National People's Congress and its Standing Committee[21]. Also, under the principle of constitutionalism, the legality of a governmental act can only be established upon explicit authorization in "law." Even though such "law" is not limited to the law enacted by the National People's Congress and its Standing Committee, a valid authorization at least should be

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Contracts], 法律适用 [JOURNAL OF LAW APPLICATION], issue 7, at 2 (2012).

[19] *See* 黄凤龙 (Huang Fenglong), 论《合同法》中的强制性规定——兼谈《合同法解释(二)》第 14 条的功能 [*On Compulsory Provisions in Contract Law: also on Function of Article 14 in Interpretation (II) of Contract Law*], 烟台大学学报(哲学社会科学版) [JOURNAL OF YANTAI UNIVERSITY (PHILOSOPHY AND SOCIAL SCIENCE)], issue 1, 45 (2011).

[20] 刑法 [Criminal Law of the People's Republic of China］(promulgated by the Nat'l People's Cong., Aug. 29, 2015, effective Aug. 29, 2015) art. 3, CLI.1.256346 CHINALAWINFO.

[21] 立法法 [Law on Legislation] (promulgated by the Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000) chapter II, CLI.1.26942 CHINALAWINFO.

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granted by "organizations empowered by laws, regulations and rules."[22]

However, in civil disputes, a judge can neither rule in favor of a defendant just because there is no penalty in law, nor can he deny the legitimacy of juristic acts agreed by private parties just because there is not explicit authorization in law. Thus, to resolve civil disputes, it is necessary to introduce other normative legal sources as supplements to statutory laws. The most important legal sources are customary laws[23] and the scholars' opinion can also be cited as the basis of adjudication when necessary[24]. Customary laws and scholars' opinion are not statutory laws. Therefore, they cannot be included into the hierarchy of legal authorities as mentioned above because such legal authorities are classified based on the hierarchy of the law-making bodies. Even if parties' intention can influence the validity of a contract (for instance, prohibition of transfer based on parties' intention, prohibition of authorization based on parties intention, etc.), it is not related to the above discussion on hierarchy of legal authorities[25].

When enhancing the hierarchy of legal authorities that can invalidate a contract, we are sending a message that legal sources in civil law, like in criminal law and public law, are only limited to statutory laws. This is contrary to our acknowledgment that the legal sources of civil law are not limited and exclusive. Thus, we need to think twice before using enhancement of legal authorities' hierarchy to restrain administrative control.

(10) Furthermore, if judicial independence as well as checks and balances can be established, then the administrative and legislative acts will be subject to review by the judiciary, which will certainly solve the problem of abusing and overreaching power. Thus, there is no need to enhance the hierarchy of legal authorities or compel the court to be self-empowered and abusing its power. Even though courts can take the courage to

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[22] 行政诉讼法［Administrative Procedure Law of the People's Republic of China］(promulgated by the Nat'l People's Cong., Nov. 1, 2014, effective May 1, 2015) paragraph 2, art. 2, CLI.1.239820 CHINALAWINFO.

[23] *See* 朱庆育 (ZHU QINGYU), 民法总论 [THE GENERAL THEORY OF CIVIL LAW], at 39–41 (2013).

[24] Vgl. F. Röhl/C. Röhl, *Allgemeine Rechtslehre*, 3. Aufl., München: Vahlen, 2008, S. 520.

[25] For general elaboration on the status of juristic acts as legal sources, *see supra* note 23, at 61–70.

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review legality and validity of State Council departmental rules, local departmental rules and other normative legal documents[26], such review is an informal one within the court system. Supposed that a departmental rule is examined to be unlawful and invalid, what is the possible legal remedies for the administrative organ that issued the rule? Also, if two courts make different decisions on the validity of a particular departmental rule, how should the general public react to this rule?

(11) Someone might argue enhancing the hierarchy of legal authorities is a feasible and effective method to limit the administrative power under current scheme, when there is no other alternatives available and judicial independence has not been established. As a matter of fact, if checks and balances are not established, enhancing the hierarchy of legal authorities in Article 52(5) of PRC Contract Law will be meaningless. If the judiciary branch cannot defend the intervention from the administrative branch, the normative legal documents lower than administrative regulations in hierarchy can still invalidate a contract through detouring "public interest" provision stipulated in Article 52(4) of Contract Law[27]. A case decided by the Supreme People's Court in 2008 ruled that the court can cite Article 52(4) of Contract Law to invalidate the contract, if the contract only violates a departmental rules provision concerning the public interest, whereas the laws (enacted by National People's Congress and its Standing Committee) and administrative regulations (promulgated by State Council) provide nothing.[28]

(12) In respect of the judicial review of administrative power, the recently revised Administrative Procedure Law of the People's Republic of China (hereinafter referred as "Administrative Procedure Law," promulgated on November 1, 2014 and effective on May 1, 2015) has demonstrated an important shift.

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[26] 最高人民法院关于裁判文书引用法律、法规等规范性法律文件的规定 [Provisions of the Supreme People's Court on the Citation of Laws, Regulations and Other Normative Legal Documents in Adjudicative Documents](promulgated by the Sup. People's Ct., Oct. 26, 2009, effective Nov. 4, 2009) art. 6, CLI.3.23702 CHINALAWINFO.

[27] *See supra* note 3, at 108.

[28] 安徽省福利彩票发行中心与北京德法利科技发展有限责任公司营销协议纠纷案 [Welfare Lottery Issuance Center of Anhui Province v. Beijing Defali Technology Development Co., Ltd. on Dispute over Marketing Agreement] (2008) 民提字第 61 号, (Sup. People's Ct. May 25, 2009) CLI.C.187966 CHINALAWINFO.

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The new Administrative Procedure Law has changed "specific administrative act" in all provisions into "administrative act." By making this change, the legislature gives up the previous position that there is a dichotomy between "abstract administrative act" and "specific administrative act" and that the abstract administrative act cannot be challenged in lawsuits. Although separate complaints against "administrative regulations, departmental rules, or universally binding decisions or orders formulated and promulgated by administrative organs" are still not accepted by courts[29], these normative documents might be subject to judicial review along with the specific complaints. Paragraph 1 of Article 53 provides, "where citizens, legal persons or other organizations consider that the normative document behind an administrative act is illegal, they may apply for judicial review of the normative documents when bringing complaints against the administrative act. These normative documents can formulated by the departments under the State Council, local people's governments and their departments." This provision only brings normative legal documents that rank lower than departmental rules into judicial review[30]. Although hesitant and conservative[31], overall it is still a meaningful step toward the establishment of judicial review in China.

(13) Considering the fact that the normative legal documents rank lower than departmental rules have already been subject to judicial review, the problem of abusing administrative power can be solved accordingly through institutional management. Thus, there is no need to completely exclude these normative legal documents from the basis of adjudication.

(14) Unfortunately, parties can not bring independent and separate complaints to challenge the legality of normative legal documents mentioned in Paragraph 1 of Article 53 in Administrative Procedure Law. Instead, a party can only apply for incidental judicial review along with claims against specific administrative act. Moreover, the court can only rule that such "documents shall

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[29] 行政诉讼法［Administrative Procedure Law of the People's Republic of China］(promulgated by the Nat'l People's Cong., Nov. 1, 2014, effective May 1, 2015) paragraph 2, art. 13, CLI.1.239820 CHINALAWINFO.

[30] *Id.* paragraph 2, art. 53.

[31] *See* 湛中乐 (Zhan Zhongle),《行政诉讼法》的"变革"与"踟蹰" [*The Administrative Procedure Law's Change and Hesitation*], 法学杂志 [LAW SCIENCE MAGAZINE], issue 3, at 31–32 (2015).

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not be used as the validity basis for the alleged administrative act" rather than declare invalidity of the normative documents. After that, the court shall "give advice to the institution which formulates the regulatory documents and may also send a copy of their advice to the people's government of the same level or to an supervising administrative institution of a higher level."[32] In this regards, judicial review of the normative legal documents established in the new Administrative Procedure Law is not independent because a party cannot bring a judicial review claim alone. It is neither uniform since the decision on its legality depends upon which court accepts and hears this case nor final because the court can only give advice to the rule-making body instead of declaring it unlawful. Therefore, a systematic judicial review of normative legal documents has not been established in China yet.

B. Nature of Legal Authorities

(15) Article 52(5) of Contract Law preliminarily limits the hierarchy (laws and administrative regulations) and nature (mandatory provisions) of legal authorities which can invalidate contracts, but applications of this concept are still unclear and broad. As for the nature of legal authorities, a violation of mandatory provision does not necessarily invalidate a contract. For instance, Paragraph 1, Article 148 of PRC Company Law provides that the director and senior officers shall not breach the duty of loyalty to the company. Paragraph 2, Article 148 further provides that if such duty is breached, the contract will not be void, rather, any income received by the director or senior officer in violation of this Article shall be treated as the property of the company.

(16) The function of PRC Contract Law Article 52(5) is equivalent to Article 134 of German Civil Code (Bürgerliches Gesetzbuch) and Article 71 of Taiwan Province Civil Code. The only difference is that the latter two contain provisos to establish exceptions and leave rooms for interpretation. For example, Article 134 of German Civil Code stipulates that "unless the legislative intent leads to a different conclusion." Also the Civil

[32] 最高人民法院关于适用《中华人民共和国行政诉讼法》若干问题的解释 [Interpretation of the Supreme People's Court on Several Issues concerning the Application of the Administrative Litigation Law of the People's Republic of China] (promulgated by the Sup. People's Ct., Apr. 22, 2015, effective May 1, 2015) art. 21, CLI.3.247453 CHINALAWINFO.

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Code Article 71 in Taiwan clarifies that "except voidance is not implied in the provision." The existence of provisos makes these two provisions serving as the rules of interpretation (Auslegungsrege1)[33]. By contrast, there is no room for interpretation in Article 52(5) due to the lack of provisos[34]. As a supplement, Article 14 of Interpretation I of the Supreme People's Court on Certain Issues concerning the Application of the PRC Contract Law narrows the "mandatory provisions" in Article 52(5) of Contract Law into "mandatory provisions on effectiveness."[35]

III. MANDATORY PROVISIONS ON EFFECTIVENESS AND MANDATORY PROVISIONS ON ADMINISTRATION

A. Concept

(17) To start with, Article 14 of the Contract Interpretation Part II bringing in the concept of mandatory provisions on effectiveness intends to facilitate the application of the Article 52(5) of the PRC Contract Law. That is to say, we only need to determine whether a provision is a mandatory provision on effectiveness when it is referred to by Article 52(5) and needs to be applied accordingly. In other words, if Article 52 does not apply, there is no need to discuss the concept of the mandatory provisions on effectiveness. Therefore, if the mandatory provisions contain provisions to define their legal effect, we can apply the provisions directly without introducing the discussion of mandatory provisions on effectiveness.[36]

(18) The concept of mandatory provisions on effectiveness in Chinese literature can be found as early as in the classification of the effective provisions and prohibitive provisions brought in

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[33] *See supra* note 16, at Rn. 103; *supra* note 4, at 5–7.

[34] *See supra* note 4, at 7.

[35] Professor Han Shiyuan thinks, after Article 14 of Interpretation (II) of Contract Law introduces the concept of "mandatory provisions on effectiveness," Article 52(5) of Contract Law is both a rule of interpretation and a general clause. *See* 韩世远 (HAN SHIYUAN), 合同内容的适法性与妥当性 [*The Legitimacy and Appropriateness of Contract Contents*], *in* 民法的解释论与立法论 [THE INTERPRETATIVE THEORY AND LEGISLATIVE THEORY IN CIVIL LAW], at 21, 23 (2015). However, it is better to say that Article 14 of Interpretation (II) of Contract is a rule of interpretation, rather than Article 52(5) of Contract Law.

[36] *See supra* note 4, at 20–21. The opposite opinion can be found in *supra* note 3, at 106.

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by Mr. SHI Shangkuan from Japan.[37] According to Mr. SHI, the mandatory provisions can be divided into effective provisions and prohibitive provisions. The former emphasizes the legal value of the violations and denies its legal effect. By contrast, the later focuses on the factual value of the violations and prohibits the act completely.[38] The legal value refers to whether a juristic act is permitted to have the same legal effect pursuant to the party's intention. If not, the juristic act is invalid (in a sense of legal judgment). The factual value refers whether a juristic act in the sense of factual judgment is permitted to occur. If not, the juristic act will be prohibited, where the violations will be subject to sanctions to prevent similar behavior.[39] Obviously, the effective provisions and the prohibitive provisions are completely different: the effective provisions invalidate the juristic act for its violation of legal regulations, while the prohibitive provisions invalidate the act inherently for its nature.

(19) Inspired by Mr. SHI Shangkuan, Article 14 of the Contract Interpretation Part II uses the phrase of mandatory provisions on effectiveness to describe what is called effectiveness provisions in Mr. SHI's theory.[40] The expression of mandatory provisions on effectiveness seems to be more rigorous from appearance, but actually is a tautology.[41] If a mandatory provision invalidates a contract for its violation thereof, that is to say, a contract will be void for violating the mandatory provisions. Then the problem is what kind of legal provision is "mandatory provisions on effectiveness." This tautology does not provide additional information to define what is mandatory provisions on effectiveness. To further understand the real contents, we will start by examining its opposite concept.

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[37] *See supra* note 4, at 6.

[38] 史尚宽 (SHI SHANGKUAN), 民法总论 [CIVIL LAW PANDECT], at 330 (China University of Political Science and Law Publisher, 2000).

[39] *Id.* at 330.

[40] *See* 曹守晔 (Cao Shouye), 《关于适用合同法若干问题的解释（二）》的理解与适用 [*The Understanding and Application of Contract Interpretation Part II*], 人民司法·应用 [PEOPLE'S JUDICIARY. APPLICATION], at 43 (2009).

[41] *See also* 苏永钦 (SU YONGQIN), 违反强制或禁止规定的法律行为——从德国民法§134 的理论与实务操作看台湾地区"民法"§71 [*Juristic Act that violates mandatory or prohibitive provision-Comments on Civil Law §71 in Taiwan based on the theory and practical application of German Civil Code §13*], 私法自治中的经济理性 [ECONOMIC RATIONALITY IN GOVERNANCE OF PRIVATE LAW], at 43 (Renmin University of China Press, 2004).

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(20) The logically opposite concept of "mandatory provisions on effectiveness" is "non-mandatory provisions on effectiveness." However, this negativity does not include any positive information. Instead, Article 15 of the Fa Fa [2009] No. 40 Guiding Opinions of the Supreme People's Court on Several Issues Concerning Trial of Cases on Disputes over Civil and Commercial Contracts in the Current Situation (hereinafter "Guiding Opinions") considers "mandatory provisions on administration" as the opposites. Thus it is fair to infer that "mandatory provisions on administration" is a tautology of "non-mandatory provisions on effectiveness." The concept of "mandatory provisions on administration," from its naming logic, conveys two piece of information. First, violation of the mandatory provisions on administration would not invalidate the contract. Second, the reason is that the mandatory provisions on administration aim at exercising administration rather than denying the contents of the contract.

(21) The judicial interpretations and cases can provide support for the above reasoning. Article 14 of the Contract Interpretation Part II lists the mandatory provisions on effectiveness as the only ground for validating contracts. It is fair to infer that the distinction between these two types of provisions is whether it will lead to a void contract.[42] One example from the Supreme People's Court Gazette is a case decided by Guangdong Meizhou Intermediate People's Court in 2009, where the court ruled that a provision regulating a particular group of people on internal affairs without involving public interests couldn't be regarded as a mandatory provision on effectiveness. The violation of these provisions would not invalidate the contract.[43] A case decided by Supreme People's Court in 2012 held that Article 16(2) of the PRC Company Law was about internal control procedure, thus couldn't be used against the opposite party of the transaction. In this regard, the provision should be regarded as mandatory provisions on administration and can not void (invalidate) a contract in general.[44] Another Supreme People's Court case in 2015 reaf-

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[42] *See supra note* 41, at 43.

[43] 梅州市梅江区农村信用合作联社江南信用社诉罗苑玲储蓄存款合同纠纷案 [Jiangnan Rural Credit Cooperatives of Meijiang District, Meizhou City v. Luo Yuanling on Dispute over Contract of Deposit], (2009) 梅中法民二终字第 75 号, (Meizhou Interm. People's Ct, Dec. 15, 2009) CLI.C.827564 CHINALAWINFO.

[44] 招商银行股份有限公司大连东港支行与大连振邦氟涂料股份有限公司、大

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firmed this position. Pursuant to the revised PRC Company Law, directors and senior managers can not provide guarantees to others without the approvals from the board of directors, the general meeting of shareholders or the board of shareholders and violate the Articles of the Company at the same time. This is a provision on internal regulation of the company and does not deal with the legality of the external guarantees without approval.[45]

(22) The issue is actually much more complicated because the Supreme People's Court does not take a consistent position on this issue. The case decided in 2012 using the expression of "in general" has indicated its uncertainty. The drafter of the Contract Interpretation Part II also expressed similar uncertainty. On the one hand, the mandatory provision on administration is regarded as the tautology of the prohibitive provisions proposed by Mr. Shi Shangkuan. On the other hand, it stipulates that violations of the mandatory provisions on administration would not necessarily invalidate the contract.[46] "Not necessarily invalidate the contract" means there is a possibility of invalidating the contract. Article 15 of the Guiding Opinions represents the official attitudes towards the uncertainty. The court should invalidate the contract based on violations of the mandatory provisions on effectiveness. And the court has discretion to determine the validity of the contract on a case-by-case basis when involving the violations of the mandatory provisions on administration. In 2007, a vice president of the Supreme People's Court affirmed this position with absolute certainty that only violations of the mandatory provisions on effectiveness would invalidate the contract. The words still ring in our ears but their position on man-

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连振邦集团有限公司借款合同纠纷案 [Dalian Donggang Sub-Branch of China Merchants Bank Co., Ltd. v. Dalian Zebon Fluorocarbon Paint Stock Co., Ltd. and Dalian Zebon Group Co., Ltd. on Dispute over Contract of Loan], (2012) 民提字第 156 号, (Sup. People's Ct. Apr. 22, 2012) CLI.C.4533634 CHINALAWINFO.

[45] 六安市创新小额贷款股份有限公司与许照群等民间借贷合同纠纷再审申请案 [Liu An City Creative Small Loan Co., Ltd. v. Xu Zhaoqun etc. on Retrial Disputer over Private Lending Contract], (2015)民申字第1684号, (Sup. People's Ct. Aug. 29, 2015) CLI.C.7998807 CHINALAWINFO.

[46] 妥善审理合同纠纷案件 维护市场正常交易秩序——最高人民法院民二庭负责人就《关于当前形势下审理民商事合同纠纷案件若干问题的指导意见》答记者问 [Judge the Contract Disputes Properly to Safeguard Normal Transaction Order of the Market-Response to Journalist's Questions on Guiding Opinions from the Principal of the Second Branch of the Civil Cases in the Supreme People's Court], 人民法院报 [PEOPLE'S COURT DAILY], July 14, 2009; *supra* note 41, at 43.

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datory provisions on administration has been stealthily changed to be "deciding the validity of contracts on a case-by-case basis" within only two years.

(23) It is undisputed that the violations of mandatory provisions on effectiveness will invalidate a contract. Also, the violations of mandatory provisions on administration may also invalidate a contract. In this regard, what is the significance of specially identifying the mandatory provisions on effectiveness pursuant to Article 14 of Contract Interpretation Part II? And what is the logic of distinguishing the two concepts of mandatory provisions on effectiveness and mandatory provisions on administration?

B. Standard

1. Overview

(24) The distinction between mandatory provisions on effectiveness and mandatory provisions on administration is only repeating the same meaning and quite ambiguous. This messy logic does not facilitate the understanding of the concept or the application of the law. The following paragraphs will discuss the determining standards.

(25) Article 16 of the Guiding Opinions tries to illustrate the standard to distinguish mandatory provisions on effectiveness and mandatory provisions on administration. "If the mandatory provision is about a contract act and the contract act harms national interests or interests of the general public absolutely, the court should invalidate the contract. If the mandatory provision is about the market access qualifications of parties or the performance of a contract rather than a particular type of contract act, the court should be more cautious in determining the validity of the contract. If necessary, the court should consult with the relevant legislative departments or request for instructions from the superior court." The above standard is still confusing and ambiguous.

2. Contracting Act and the Performance of the Contract

(26) The concept of contracting act in Article 16 of the Guiding Opinions refers to the obligatory contract, since it is an opposite concept of the performance of the contract. The obliga-

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tory contract only establishes the obligations of the contracting parties and does not have external effect in general. If there is no performance of the contract, it is hard to imagine that the contracting act itself would absolutely harm national interests or interests of the general public. For example, in a drug deal, what really harms national interest or interests of the general public is the drug transactions based on the performance of the sales contracts rather than the contracting act itself that only tends to establish an obligation on drug transfer. However, in the opinion of the PRC Supreme People's Court, the contracting act itself is much more harmful and serious with respect to the national interests or the interests of the general public than the performance of the contract. Therefore, the Supreme People's Court stipulates that the contracting act itself should be regarded as invalid while the performance of the contract should be subject to further careful consideration. This interpretation is quite confusing and unreasonable.

3. National Interests or Interests of the General Public

(27) Article 16 of Guiding Opinions clearly intends to judge the mandatory provisions on effectiveness by the basic criterion of national interests and interests of the general public. The logic can be summarized as: mandatory provisions on effectiveness are mandatory provisions which intend to maintain national interests or interests of the general public. Contracts that violate mandatory provisions on effectiveness are invalid.[47] One case decided by the Jiangsu Xuzhou Intermediate People's Court in 2013 is a typical example of this idea.[48] "If the legislation of mandatory provisions is to protect national interests as well as interests of the general public, and violation of the provisions will damage the national interests or the general public, such provisions are mandatory provisions on effectiveness. On the other hand, if violation of the provisions does not necessarily damage the national interests or interests of the general public, but only the interests of contracting parties, such mandatory provisions are

[47] *See supra* note 3, at 106.

[48] 江苏徐州中院判决张兆民诉沛县双楼村委会民间借贷纠纷案 [Zhang Zhaomin v. Villagers' Committee in Pei County on Dispute over Private Lending Contract], (2013)徐民终字第 293 号, (Jiangsu Xuzhou People's Interm. Ct., Jul. 23, 2013) CLI.C.2706426 CHINALAWINFO.

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mandatory provisions on administration."[49] This is a verdict about Article 28 of the Organic Law of the Villagers' Committee. In the Organic Law of the Villagers' Committee, the provisions that villagers' group meetings should be held when dealing with matters such as the management of villager groups are to restrict the internal management of rural collective organizations. Since the violation does not harm the national interests or the interests of the general public, the villagers' committee can not argue that the contract is void simply because it failed to receive consents from 2/3 villagers.[50]

(28) However, this approach is questionable. First of all, it's confusing to define "national interests" or "interests of the general public." In a case decided by the Supreme People's Court in 2014 involving disposal of state-owned property, the trial court and the appellate court both found that the disposal violating legal procedures would result in the loss of state-owned property and thus damage the national interests and the interests of the general public.[51] But in the retrial, the Supreme People's Court held, "under the system of market economy, state-owned enterprises are equal in status with other market players involving in market transactions and their asset interests cannot be equated with the social and public interests." Therefore, the application of Article 52(5) of the Contract Law is not correct.

Another case in Beijing Second Intermediate People's Court[52] involving mandatory provisions on matters decided by villagers' committee takes a different view from the above men-

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[49] 李晓东 (Li Xiaodong), 江苏徐州中院判决张兆民诉沛县双楼村委会民间借贷纠纷案——村委会内部管理行为的规定不能对抗合同第三人 [*A Judgment on Private Lending Disputes between Zhang Zhaomin and Shuanglou Village Committee in Pei District Decided by the Jiangsu Xuzhou Intermediate People's Court-An Internal Regulation inside the Villagers' Committee Cannot Bind a Third Party of the Contract*]，人民法院报 [PEOPLE'S COURT DAILY], May 8, 2014, at layout 6.

[50] *Id.*

[51] 林嘉锋等诉甘肃省中国青年旅行社房屋买卖合同纠纷案 [Lin Jiafeng v. Youth Hostel of Jiangsu Province on Dispute of Contract for Property Sale and Purchase], (2014) 民提字第 216 号, (Sup. People's Ct. Feb. 26, 2014) CLI.C.6320887 CHINALAWINFO.

[52] 于晓明等诉北京市怀柔区怀柔镇南关村村委会土地租赁合同案 [Yu Xiaoming etc. v. Villagers' Committee of Nanguan Village, Huairou County, Huairou District, Beijing on Dispute over Contract Land Lease], (2011) 二中民终字第 02520 号, (Beijing Second Interm. People's Ct. Sep. 20, 2011) CLI.C.7207053 CHINALAWINFO.

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tioned one in Xuzhou.[53] The Beijing Court found, "the lease contract signed by the appellant and the Nanguancun Villagers' Committee does not follow the procedures of village democratic agreement, and thus violates the relevant laws and regulations. It is correct for the Huairou Arbitration Committee on Rural Contract to confirm that the lease contract signed by both parties is invalid for the lack of democratic agreement by villagers' meeting or the villagers' representative meeting." And it also stated, "the cadres of the original villagers' committee abuse their authority in renting with an obviously low price and harm the interests of the village collective… the trial court's opinion on dismissing the claims was proper and we affirmed." It is clear that the mandatory provisions in Organic Law of the Villagers' Committee are used as an invalidation basis, and the collective interests of the village are also regarded as part of "national interests or interests of the general public."

(29) Furthermore, even assuming that the difficulties in determining what national interests are and what interests of the general public can be disregarded, the obstacles are not completely removed. The national interests and interests of the general public are different from individual interests. That is to say, the concepts go beyond the scope of private autonomy. If the mandatory provisions represent some kind of abstract interest in public order and exclude private autonomy (*see* para.1), all kinds of mandatory provisions are intended to protect the national interests and interests of the general public, not limited to the mandatory provisions on effectiveness. Thus, it is not an appropriate standard to distinguish the mandatory provisions on effectiveness and the mandatory provisions on administration. In addition, there are plenty of methods to protect national interests and interests of the general public, and these methods have no direct connections with the validity of the contract.

(30) Last but not least, five grounds for invalidating contracts codified in Article 52 of PRC Contract Law should be regarded as parallel and mutually exclusive in application. Subsection 1, 2 and 4 explicitly indicate that they concern national interests and interests of the general public. Subsection 3 is about illegal contract and thus harms national interests and interests of

[53] *Supra* note 49.

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the general public naturally. In this regard, if we again rely on national interests and interests of the general public as the standard to determine the mandatory provisions under subsection 5, this particular subsection will be meaningless, because the above 4 subsections can be applied directly.

4. Market Access Qualifications

(31) Mr. Shi Shangkuan uses market access qualifications as an example of prohibitive provisions.[54] Article 16 of the Guiding Opinion also lists market access qualifications as typical mandatory provisions on administration.

(32) However, when the government creates market thresholds, the decision is based on the its responsibility to maintain the interests of general public. Therefore, market entities without qualifications did harm interest of the general public. In this regard, it is hard to tell whether the market access qualifications are mandatory provisions on administration or mandatory provisions on effectiveness, if we apply the "national interests or interests of the general public" as the basic criteria to make the decision.

(33) In fact, in relevant judicial interpretations such as Article 1 and Article 4 of Interpretation of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases of Dispute over Contracts on Undertaking Construction Projects[55] (hereinafter "Interpretation of Contracts on Undertaking Construction Projects"), the Supreme People's Court does not hesitate too much to include "market access qualifications" into the applicable scope of Article 52(5) of Contract Law. The "exceptions" are that the court would not invalidate contracts if the unqualified entity has obtained approval for market access before the completion of construction projects (*see* Article 5 of Interpretation of Contracts on Undertaking Construction Projects), or before the filing of the suit (*see* Article 2 of Interpretation of Contracts for the Sale of Commodity Houses). That is to say, the

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[54] *See supra* note 38, at 331–32.

[55] 最高人民法院关于审理建设工程施工合同纠纷案件适用法律问题的解释 [Interpretation of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases of Dispute over Contracts on Undertaking Construction Projects] (promulgated by the Sup. People's Ct., Oct. 25, 2004, effective Jan. 1, 2005), art. 1 and art. 4, CLI.3.55723 CHINALAWINFO.

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contracts will be void if the entity fails to obtain the market access approval within certain time limits. At the same time, while the former part of Article 10 of Contract Interpretation Part I provides that "people's courts shall not invalidate contracts on grounds that parties sign the contracts beyond their business scope," the latter part of Article 10 immediately stipulates that "but contracts that violate national regulations on restricted business, franchise, and prohibited business provided in law and administrative regulations are excluded." Due to the restrictive effect of this proviso, the former part of Article 10 is only applicable in contracts that go beyond the business scope freely chosen by parties of the contracts. All the analysis sends the same message: in courts' view, "market access qualifications" are typical mandatory provisions with administrative function, and only constitute a factor that may influence the validity of contracts.

(34) Such finding is also supported by judicial cases. In a dispute over the lease of port terminal, the appellate verdict in Shanghai No. 1 Intermediate People's Court[56] overruled the opinion of Songjiang District People's Court on the validity of a contract[57]. The Shanghai No. 1 Intermediate People's Court does not endorse the opinion that lacking "market access qualifications" would not affect the validity of contract. Instead, the court analyzes that the port at issue is an old port even before the Port Law took effect. Thus, there is no way for the competent authority to issue a license at that time. "Invalidating all the lease contracts for the lack of license is not consistent with the legislative purpose of Article 22." In another case on pawn broking franchise,[58] Shanghai No. 1 Intermediate People's Court even points out that "the United Pawn's lending money to Ai Minglu for investment in stock shares is invalid, because it constitutes dis-

[56] 上海赛强铸造材料有限公司与上海桥仙装潢材料有限公司码头出租合同纠纷上诉案 [Shanghai Saiqiang Foundry Material Co., Ltd. v. Shanghai Qiaoxian Decoration Material Co., Ltd. on Dispute over Contract for Port Lease] (2008) 沪一中民二(民)终字第 1062 号, (Shanghai First Interm. People's Ct., 2008) CLI.C.1762352 CHINALAWINFO.

[57] (2007)松民三(民)初字第 1566 号, (Songjiang District People's Ct., 2007). The original verdict is not available online and an introduction article written by Songjiang District People's Court, available at http://www.zaishenlvshi.com/html/62-1/1262.htm

[58] 艾明路诉上海联合典当行有限公司典当合同纠纷案 [Ai Minglu v. Shanghai Lianhe Pawn Co., Ltd. on Contract Dispute] (2011)沪一中民六(商)终字第 115 号, (Shanghai First Interm. People's Ct. Sep. 22, 2011) CLI.C.2791475 CHINALAWINFO.

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guised margin trading and short selling; therefore, it exceeds the franchise scope of pawn shops and shall be void."

The Supreme People's Court cases are much more typical and representative. "According to relevant laws and regulations regarding the acquisition and transfer of mining rights, including the Mineral Resources Law of the People's Republic of China and its implementation rules, the Measures for the Administration of Transfer of Mineral Exploration Right and Mining Right (promulgated by State Council), and the Tentative Provisions for Administration of Granting and Assigning Mining Industry Rights (issued by Ministry of Land and Resources), the mining and management right is a type of concession that requires strict review procedures. The lease agreement at issue does not comply with the approval procedures; thus it is invalid for violating Contract Law Article. 52(5)."[59] Afterwards, the Supreme People's Court also stated in another case[60], "(Huandun Company) violated the mandatory provisions that construction enterprise can only carry out its construction activities within the scope permitted after obtaining the according qualification certificate. Pursuant to Article 52(5) of the Contract Law and Article 1 of the Interpretation of Contracts on Undertaking Construction Projects, the construction contract is invalid because the contracting party Huandun Company pretended to be No. 5 Construction Company of China No.1 Metallurgical Construction Corporation and used a fake construction qualification.

(35) Another type of market access mandatory provisions relates to the nature of contract subjects. That is to say, the circulation of the subject itself is prohibited or limited with respect to transactions. For example, precursor chemicals are materials for drug production. Thus, there should be control over its circulation in the market. Article 9 and Article 14 of the Regulation on the

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[59]陈允斗与宽甸满族自治县虎山镇老边墙村民委员会采矿权转让合同纠纷案 [Chen Yundou v. Villagers' Commitee of Kuandian Manchu Autonomous County Hushan Town Lao Bianqiang Village on Dispute over Contract for Mining Rights Transfer] (2011)民提字第 81 号, (Sup. People's Ct. Nov. 30, 2011) CLI.C.826690 CHINALAWINFO.

[60] 齐河环盾钢结构有限公司与济南永君物资有限责任公司建设工程施工合同纠纷案 [Qihe Huandun Structural Steel Co., Ltd. v. Jinan Yongjun Supplies Co., Ltd. on Dispute over Contract for Construction] (2011)民提字第 104 号, (Sup. People's Ct. Nov. 17, 2011) CLI.C.880250 CHINALAWINFO.

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Administration of Precursor Chemicals[61] relate to the market access qualifications to control the operating and purchasing the precursor chemicals, definitely falling under the category of mandatory provisions on administration. However, if we do not invalidate those contract and their enforcement for disqualification, the government will lose its control over the illegal circulation of precursor chemicals. Viewed from the legislative intent, these provisions possess obvious features of mandatory provisions on effectiveness. As a result, how can we maintain the distinction between mandatory provisions on effectiveness and mandatory provisions on administration?

(36) Article 16 of the Guiding Opinion[62] is centered on "contracting act ," stretching forwards to "market access" and afterwards to "contractual performance", tries to draw a relatively clear line between mandatory provisions on effectiveness and mandatory provisions on administration based on the standards of "national interests or societal public interests." As analyzed above, such hard effort could only worsen the situation of adopting concepts with a wrong logic.

C. Types of Judicial Cases

1. Overview

(37) So far, it has shown that judicial interpretations that distinguish mandatory provisions on effectiveness and mandatory provisions on administration serving as grounds of invalidating contracts based on Article 52(5) of Contract Law are not worth praising. However, the previous part of this article focuses on conceptual analysis. To avoid talking about stratagems only on paper, it is necessary to look into specific judicial applications.

(38) After the issuance of Contract Interpretation Part II and the Guiding Opinion in 2009, more and more judges begin to

[61]易制毒化学品管理条例 [Regulation on the Administration of Precursor Chemicals] (promulgated by the St. Council, Aug. 26, 2005, effective Nov. 1, 2005) art. 9 and art. 14, CLI.2.59923 CHINALAWINFO.

[62]最高人民法院印发《关于当前形势下审理民商事合同纠纷案件若干问题的指导意见》的通知 [Guiding Opinions of the Supreme People's Court on Several Issues concerning the Trial of Cases of Disputes over Civil and Commercial Contracts under the Current Situation] (promulgated by the Sup. People's Ct., Jul. 7, 2009, effective Jul. 7, 2009) art. 16, CLI.3.119232 CHINALAWINFO.

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make judicial analysis by consciously using the concepts of mandatory provisions on effectiveness and mandatory provisions on administration. Excluding those judgments whose concepts are only decorative or whose reasoning is unfathomable, there are primarily five types of valuable judgements, namely, market access qualifications, internal regulations violations, administrative approval deficiencies, formality deficiencies, and criminal law violations. As previously analyzed (*see* para. 31–35), mandatory rules involving market access qualifications are often the bases to invalidate the contract, but the distinction between "mandatory provisions on effectiveness" and "mandatory provisions on administration" does not apply for this type. Cases under the other four types also appear to be misleading and confusing when applying such dichotomy.

2. Internal Regulations Violations

(39) Cases of this type involve internal regulations violations under private law, of which the China Merchants Bank case[63] is the most typical one. The court's judgment categorized Article 16(2) of the Company Law as mandatory provisions on administration by reasoning that "internal control procedures are not binding on the counterparty in the transaction." By contrast, a previous case[64] from Guangdong High People's Court held against China Xinda Asset Company Shenzhen Branch's claims that Article 16 of the Company Law is an internal corporate governance rule and is not binding on the company's external relations, and declined the argument that an internal regulation rule is not a mandatory provision on effectiveness. Judgments consistent with the China Merchants Bank case include Zhuzhou Zhengcheng Electronic Technology Co., Ltd. v. Wu Wenhua et

[63]招商银行股份有限公司大连东港支行与大连振邦氟涂料股份有限公司、大连振邦集团有限公司借款合同纠纷案 [Dalian Donggang Sub-Branch of China Merchants Bank Co., Ltd. v. Dalian Zebon Fluorocarbon Paint Stock Co., Ltd. and Dalian Zebon Group Co., Ltd. on Dispute over Loan Agreement] (2012)民提字第 156 号, (Sup. People's Ct. Apr. 22, 2014) CLI.C.4533634 CHINALAWINFO.

[64]中国信达资产管理股份有限公司深圳市分公司诉深圳市赛臣软件科技有限公司、江西省翠林山庄有限公司等借款合同纠纷案 [Shenzhen Office of China Cinda Asset Management Co., Ltd. v. Shenzhen Saichen Software Technology Co., Ltd. and Jiangxi Cuilin Village Co., Ltd., et al. on Dispute over Contract of Loan] (2012)粤高法民二终字第 19 号, (Guangdong High People's Ct. Jun. 19, 2012) CLI.C.3673184 CHINALAWINFO.

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al.[65] (Article 16 of the Company Law), Zhang Bo et al. v. Hunan Dingwang Investment Co., Ltd.[66] (Article 16(2) of the Company Law), and Wenzhou Jiujiu Hotel Management Co., Ltd. v. Wenzhou Da Fulin Boutique Hotel Co., Ltd.[67](Article 16 and Article 148 of the Company Law).

(40) Indeed, invalidating contracts based on Article 16 of the Company Law in the China Xinda case merits further discussions. But it does not mean that treating Article 16 of the Company Law as a mandatory provision on administration deserves praising. The key is not to identify a more accurate categorization, but to understand the dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration is problematic. Violation of the Company Law Article 16 is unauthorized agency for performance exceeding the scope of authorization in private law.[68] The contract involved might be void not because it violates a mandatory provision on effectiveness under Article 52(5) of the Contract Law, but because it lacks a ratification from the company. Even without ratification, the contract might still be valid, not for the reason that Article. 16 of the Company Law is a mandatory provision on administration, but based on the protection for reliance under the apparent agency theory. In other words, no matter whether the contract is valid or not, the determination of its legal effect is note relevant to Article. 52(5) of the Contract Law.

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[65]株洲政成电子科技有限公司与吴文华等民间借贷纠纷上诉案 [Zhuzhou Zhengcheng Electronic Technology Co., Ltd. v. Wu Wenhua et al. on Dispute over Contract for Private Lending] (2014)湘高法民一终字第 4 号, (Hunan High People's Ct. Feb. 12, 2014) CLI.C.2679825 CHINALAWINFO.

[66]张波等与湖南定王投资股份有限公司等民间借贷纠纷上诉案 [Zhang Bo et al. v. Hunan Dingwang Investment Co., Ltd. on Dispute over Contract for Private Lending] (2015)湘高法民一终字第 269 号, (Hunan High People's Ct. Sep. 10, 2015) CLI.C.7354894 CHINALAWINFO.

[67]温州市玖玖旅馆管理有限公司等与温州市大富林精品酒店有限公司债权转让合同纠纷上诉案 [Wenzhou Jiujiu Hotel Management Co., Ltd. v. Wenzhou Da Fulin Boutique Hotel Co., Ltd. on Dispute over Contract for Assignment of Creditor's Rights] (2015)浙商外终字第 12 号, (Zhejiang High People's Ct. Apr. 14, 2015) CLI.C.6249307 CHINALAWINFO.

[68] It's meaningless to distinguish "agency" or "representation" in the case of establishing a contract under the name of a company. For relevant analysis, *see supra* note 23, at 448. As to the validity of guarantee made by the legal representative who exceeds the power, *see* 高圣平 (Gao Shengping), 担保物权司法解释起草中的重大争议问题 [Significant Issues in Drafting Judicial Interpretations of Security Law], 中国法学 [China Legal Science], issue 1, at 229–231 (2016).

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(41) It is a comfort to see that the China Merchants Bank case finally applies Article 50 of the PRC Contract Law in support of the contract validity through reasoning that the counterparty's goodwill constitutes apparent agency, getting rid of the dichotomy to some extent. By contrast, the two judgments by Hunan High People's Court are completely dominated by the dichotomy in its path of finding laws, with no regard to unauthorized agency. Zhuzhou Zhengcheng Electronic Technology Co., Ltd. v. Wu Wenhua et al. finding that the counterparty is in bad faith but turns suddenly to invalidity the contract based on Article 52(5) of the Contract Law. Zhang Bo et al. v. Hunan Dingwang Investment Co., Ltd. held the contract valid for violating only a mandatory provision on administration, giving no consideration to whether the counterparty has a good will or not.

(42) In fact, Beijing High People's Court once made a clear analysis about the application of Company Law Article 16, shortly after the enforcement of Contract Interpretation Part II. The Court refused to identify Article 16 of the Company Law as a mandatory provision on effectiveness under Article. 14 of the Contract Interpretation Part II, while at the same time, did not categorize it as a mandatory provisions on administration.[69] Instead, the Court reasoned that such "agency beyond authority" should be solved within the framework of unauthorized agency. It is a pity that although this case was published on the gazette of the Supreme People's Court, the dichotomy logic in the China Merchants Bank case — "a rule is either a mandatory provision on effectiveness or a mandatory provision on administration" — is much more influential, so that judgments afterwards all followed the similar reasoning in the China Merchants Bank case.

(43) Even if leaving behind the discussion over whether it is tenable in concept (*see* para. 17–36), it should be clear that the dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration is only a reference coordinate in applying Article. 52(5) of the Contract Law. The majority of laws and regulations referred are public law or criminal statutes, going

[69]中建材集团进出口公司诉江苏银大科技有限公司等担保合同纠纷案 [China National Building & Equipment Import and Export Corp. v. Jiangsu Yinda Technology Co., Ltd. et al. on Dispute over Guarantee Contract] (2009)高民终字第 1730, (Beijing High People's Ct. Sep. 22, 2009) CLI.C.514282 CHINALAWINFO.

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beyond the scope of private law (*see* para. 3). In other words, the dichotomy is only functional in the framework of mandatory provisions under Article 52(5) (*see* para. 17), and the mandatory provision covered is much narrower than the whole picture of mandatory provisions. If following the theory of Mr. Shi Shangkuan, one should understand that Mr. Shi has already excluded provisions with other effectiveness rules from the context of dichotomy when making such distinctions.[70] Transactions in excess of authorities in private law — no matter whether it excesses the authority of agency or disposal — belong to the type of provisions "with other effectiveness rules", where Article 52(5) of the Contract Law does not apply.

(44) In addition, analyzing the transactions in excess of authority in the context of such dichotomy will inevitably result in further conceptual confusions. When courts extend the concept of mandatory provisions on administration from emphasizing administrative management to "corporate internal management", they are mixing up "management" in public law and private law. Pursuing this logic, all provisions about agency authority (and any other agency issues in private law) will be classified into mandatory provisions on administration. A greater impact will be the disappearance of the distinction between authorities in private law and public law.

(45) The difference in regulatory logic between authorities in public law and private law can be demonstrated in the judicial application of Organization Law of the Villagers' Committees of the People's Republic of China (hereinafter "Organization Law of the Villagers' Committees")[71]. The villagers' committee is established in a way similar to a public legal person (Organization Law of the Villagers' Committees Article 3(2)), with partial function of a public legal person (Organization Law of the Villagers' Committees Chapter 2). However, the villagers' committee categorized as "organization of self-government" among villagers (Organization Law of the Villagers' Committees Article 2(1)), adopts a decision making mechanism similar to that of a private

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[70] *See supra* note 38, at 330.

[71] 村民委员会组织法 [Organic Law of the Villagers' Committees of the People's Republic of China] (Promulgated by the Standing Committee of the National People's Congress, Oct. 28, 2010, effective Nov. 4, 1998) CLI.1.139685 CHINALAWINFO.

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legal person like a company (Organization Law of the Villagers' Committees Chapter 4). Therefore, with regard to the decision items listed in Art. 24 of Organization Law of the Villagers' Committees, there will be different paths of law-findings depending on different nature of the matter. Decisions made in excess of a villagers' committee authority can be invalid from the perspective of public law with reference to Article 52(5) of the Contract Law.[72] Also, the decision can be regarded as a company decision, where the unauthorized agency theory apples. With no relation to Article 52(5) of the Contract Law, decisions and contracts in excess of authorities will be void for failure to obtain the ratification from the "company" (villagers' committee).[73] Anyway, the logic in Zhang Zhaomin v. Pei Town Shuanglou Villager's Committee is untenable, where the Court found a contract "is not binding on a third party"[74] on the ground that mandatory provisions on administration only regulate "internal management behavior," regardless of the goodwill of the counterparty. (*see* para. 27)

3. Administrative Approval Deficiencies

(46) As mentioned above, the violations of the internal regulations in private law, either in respect of constitutive elements or legal effects, are not within the scope of Article 52(5) of the Contract Law. Solving the problems under the dichotomy of mandatory provisions on effectiveness and on administration definitely leads to wrong law-findings. However, this does not mean violations of administrative regulations in public law necessarily falls within the scope of such dichotomy.

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[72] 于晓明等诉北京市怀柔区怀柔镇南关村村委会土地租赁合同案 [Yu Xiaoming et al. v. Villagers' Committee of Beijing Huairou District Huairou Town Nanguan Village on Dispute over Land Lease] (2011)二中民终字第 02520 号, (Second Interm. People's Ct. of Beijing. Sep. 20, 2011) CLI.C.7207053 CHINALAWINFO.

[73] 张守石等与洮南市瓦房镇伞春吉等农业承包合同纠纷申请案 [Zhang Shoushi et al. v. San Chunji from Zhao Nan City Wa Fang Town on Dispute over Contract for Agricultural Contracting] (2014)吉民申字第 851 号, (Jilin High People's Ct. Oct. 10, 2014) CLI.C.3469226 CHINALAWINFO (only the determination of the nature of "unentitled disposal" needs further discussions).

[74] 张兆民诉沛县双楼村委会民间借贷纠纷案 [Zhang Zhaomin v. Pei Town Shuanglou Villagers' Committee on Dispute over Contract for Private Lending] (2013) 徐民终字第 293 号, (Xuzhou Interm. People's Ct. Jul. 23, 2013) CLI.C.2706426 CHINALAWINFO.

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Apart from general market access threshold (*see* para. 31–35), the government can also regulate market behavior by setting administrative approval as a constitutive element for contract validity. Since such approval is a positive requirement on validity, the contract does not take effect until the requirement is met. As a result, this kind of regulation does not fall within the scope of Article 52 of the Contract Law. However, a large number of judicial decisions have discussed such regulations in the context of dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration.

(47) Cases involving administrative approval deficiencies are mainly about the transfer of right of use on state-owned lands, and relevant provisions are mainly from the Law on Administration of Urban Real Estate, including Article 38, Article 39[75],

[75] 桂馨源公司诉全威公司等土地使用权转让合同纠纷案[Guixinyuan Ltd., Co v. Quanwei et al. on Contract Disputes over Right of Use on Land] (2004)民一终字第 46 号, (Supreme Ct. Aug. 31, 2004) CLI.C.67373 CHINALAWINFO; 河南花园置业有限公司与河南鑫苑置业有限公司土地使用权转让合同纠纷上诉案[Henan Garden Settlement Co., Ltd. and Henan Xinyuan Real Estate Co., Ltd.], (2004) 民一终字第 26 号(Supreme Ct. 2006) CLI.C.183564 CHINALAWINFO; 福溢工艺（南京）有限公司与南京赛特欧运输设备制造有限公司房屋买卖合同纠纷上诉案[Fuyi Craft (Nanjing) Co., Ltd. v. Nanjing Saiteou Transportation Equipment Manufacturing Co., Ltd. on Appeal Disputes over Real Estate Sales Agreements] (2008)宁民四终字第 2617 号, (Nanjing Interm. People's Ct. 2008) CLI.C.1762246 CHINALAWINFO; 陈险峰与朱超峰房屋买卖合同纠纷案[Chen Xianfeng v. Zhu Chaofeng on Disputes over Real Estate Sales Agreement] (2011)豫法民申字第 01613 号(Henan High People's Ct. Nov. 12, 2012), CLI.C.1470919 CHINALAWINFO; 桑翠平与李玉林房屋买卖合同纠纷申请案[Sang Cuiping v. Li Yulin on Retrial Disputes over Real Estate Contract] (2012)豫法立二民申字第 01699 号(Henan High People's Ct. Mar. 6, 2013), CLI.C.1972296 CHINALAWINFO; 再审申请人许翠金与被申请人郑昱、韦木昇物权保护纠纷案 [Xu Cuijin v. Zheng Wei, Wei Musheng on Retrial Disputes over Property Protection] (2013)豫法立二民申字第 00525 号, (Henan High People's Ct. Sept. 9, 2013) CLI.C.2221475 CHINALAWINFO); 再审申请人曹俊辉与被申请人顾建超及一审被告、二审被上诉人登封市颖南建筑安装有限公司房屋买卖合同纠纷案 [Cao Junhui v. Gu Jianchao on Retrial Disputes over Real Estate Sales Agreements] (2013)豫法立二民申字第 00535 号, (Henan High People's Ct. Oct. 23, 2013) CLI.C.2222697 CHINALAWINFO; 再审申请人灵宝市金宝典当有限责任公司与被申请人徐红生、一审第三人张治军所有权确认纠纷案[Lingbao Jinbao Pawn Co., Ltd. v. Xu Hongsheng on Retrial Disputes over Ownership Determination] (2013)豫法立二民申字第 00691 号, (Henan High People's Ct. Jul. 26, 2013) CLI.C.2220591 CHINALAWINFO; 淮安市华海房地产开发有限公司与淮安市大成建筑有限公司土地使用权转让合同纠纷上诉案[Huaian Huahai Real Estate Development Co., Ltd. v. Huaian Dacheng Construction Co., Ltd. on Appeal Disputes over Land Use Right Transfer Agreement] (2014)苏商终字第 00532 号, (Jiangsu High People's Ct. Mar. 13, 2015) CLI.C.6746150 CHINALAWINFO; 王念五等与傅名贤等房屋买卖合同纠纷申请案[Wang Nianwu etc. v. Fu Mingxian etc. on Retrial Disputes over

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Article 40, Article 61 and its relevant article-Article 45 of Provisional Regulations concerning the Grant and Assignment of the Right to Use State Owned Land in Urban Areas (Provisional Regulations on State Owned Land in Urban Areas)[76]. All of these judgments upheld the validity of the transfer agreements except one judgment from Zhengzhou Intermediate People's Ct. Nov. 3 2010, (CLI.C.681773 CHINALAWINFO)[77]. During the later period of enforcing the Contract Interpretation Part II, courts all follow the same dichotomy logic to analyze the validity of contracts.

(48) Clearly, judges in *Guixinyuan Company v. Quanwei Company, et al*. are not familiar with the such dichotomy, finding the violation of Law on Administration of Urban Real Estate Clause 1, Article 39 as "a defect in the subject matter of the transfer, which does not affect the validity of the transfer agreement"[78]; Judgment of *Henan Garden Settlement Co., Ltd. v. Henan Xinyuan Real Estate Co., Ltd*. went further by clearly pointing out that Article 38 and Article 39 of Law on Administration of Urban Real Estate are "mandatory provisions on administration made by the administrative departments, to regulate registration changes on land right of use for non-qualified land, rather than mandatory provisions governing the validity of the transfer agreements."[79] These two decisions both adopted the dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration. It is noteworthy that the two Supreme Court judgements before Contract Interpretation Part II both recognized that the Law on Administration of Urban Real Estate regulates the transfer of right to use on the state-owned lands, rather than the transfer agreement setting the obligation to transfer.

Real Estate Sales Agreement](2014)渝高法民申字第 00266 号, (Chongqing High People's Ct. May 19, 2014) CLI.C.5728028 CHINALAWINFO.

[76]郑州市中原区人民政府与郑州市威仁实业有限公司合同纠纷案[Zhengzhou Zhongyuan District Government v. Zhengzhou Weiren Industry Co., Ltd. on Contract Disputes] (2010)郑民三终字第 912 号, (Zhengzhou Interm. People's Ct. Nov. 3 2010)CLI.C.681773 CHINALAWINFO; 赵永平诉四平市五鑫储运有限公司租赁合同纠纷案[Zhao Yongping v. Siping Wuxin Storage Co., Ltd. on Lease Contract Disputes](2015)吉民申字第 571, (Jilin High People's Ct. May 14, 2015) CLI.C.7289944 CHINALAWINFO.

[77] *Id*, Zhongyuan Government v. Weiren.

[78] Guixinyuan v. Quanwei, *Supra* note 75.

[79] Henan Garden v. Xinyuan, *Supra* note 75.

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(49) After the Contract Interpretation Part II and the Guiding Opinion establish the dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration in 2009, the judiciary quickly applied this dichotomy, and the court reasoning also experienced a subtle but far-reaching change.

The new model of reasoning is highly consistent, as represented by a judgement of Nanjing Intermediate People's Court (CLI.C.1762246 CHINALAWINFO)published in People's Judiciary • Case that stated "Clause 6, Article 38 of Law on Administration of Urban Real Estate is a provision on administration rather than on effectiveness. Violation of this provision does not necessarily lead to void contracts. Although the two parties did not obtain the real estate certificate after signing the transfer agreement of land and the attached real estate, the legal effect of the transfer agreement was not affected."[80] There are three main points of the model: first, Article 38 of Law on Administration of Urban Real Estate is a mandatory provision on administration; second, the transfer contracts (sale contracts) of real estate or land use rights are not void for violations of mandatory provisions on administration; third, real estate ownership or land use rights remain unchanged until the conditions required by Article 38 of Law on Administration of Urban Real Estate are met.

(50) Such judgments were generally built upon the theory of juristic act of real right (Rechtsgeschäfts).[81] The distinction between obligation setting and the right transfer does help to avoid the misjudgment caused by the confusion of legal relations[82], but this does not mean that the model itself is accurate.

(51) First of all, Article 38 and other articles of Law on Administration of Urban Real Estate regulate only transfer of rights. Even these articles are mandatory provisions on administration, the subject matters regulated are the acts of right transfer under the separate principle of juristic act of real right. It is impossible for the "transfer contracts" violate this category of the provisions, when the contracts only set the obligation of transfer-

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[80] Fuyi v. Saiteou, *Supra* note 75.

[81] *See* 钱锋 (Qian Feng), 唐明 (Tang Ming), 房屋未领取产权证不影响协议转让 [*No Acquisition of the Housing Property Certificate Does Not Influence the Transfer Contract*], 人民司法·案例 [PEOPLE'S JUDICIARY • CASES], Volume 8, at 29 (2009).

[82] Zhongyuan Government v. Weiren, Supra note 76.

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ring rights and, therefore, lying beyond the scope of regulations. When claiming that "the transfer contract is not void due to violation of mandatory provisions on administration", the court, on the one hand, distinguishes between the obligation setting act and the right transfer act, but on the other hand still regards the obligation setting act as the subject matter of this mandatory provisions on administration. The above reasoning jumping between different legal relationships and concept understandings is less convincing compare to those made by the Supreme People's Court (*see* para. 48) in the period of Contract Interpretation Part II.

(52) Second, almost all requirements in Article 38 of Law on Administration of Urban Real Estate intend to affect the validity of the act of transfer directly rather than the transfer contract that sets the obligation. Clause 1, Article 38, and the referred Article 39 of Law on Administration of Urban Real Estate may leave some room for interpretation. But Clause 2 to Clause 6 of Article 38 are all within the scope of private law, either constituting prohibitions on transfer (Clause 2, Clause 5) belongs to relative invalidation (*see* para. 94)[83], or constituting unauthorized disposal (Clause 3, Clause 4, Clause 6), which should never be categorized as mandatory provisions on administration.

(53) Third, the approval procedure provided in Article 40 and Article 61of Law on Administration of Urban Real Estate and Article 45 of Provisional Regulations on State Owned Land in Urban Areas all have administrative functions, belonging to the mandatory provisions on administration. At the same time, these provisions are positive requirements for contract formation in Clause 2, Article 44 of the Contract Law. Without obtaining the administrative approval under these provisions, the transfer of real estate ownership or land use rights does not take effect, rather than invalid as provided in Article 52 of the Contract Law.

(54) In summary, Article 52(5) shall not be applied in cases involving administrative approval deficiencies. Some provisions concerning only private law authorities, even if being codified into public administrative law, are not belong to mandatory provisions on administration. While the others with administrative function are basic thresholds of contract formation, which are not related to Article 52 of PRC Contract Law.

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[83] *Supra* note 23, at 303–06.

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(55) Compared to wrongful results in identifying the nature, the logic process of reasoning may be worth more attention. Initially, Article 38 of Law on Administration of Urban Real Estate shall be exclude from judging the validity of the "transfer contracts" simply by resorting to the separate principle of juristic act of real right. However, a large amount of judgments still stick to the dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration at the price of mixing up different layers of legal relations. Following this misleading dichotomy logic, courts found "transfer contracts" valid because it merely violated "mandatory provisions on administration". Even worse, Henan High People's court has already noticed that Article 6 of Rules for Implementation of the Land Administration Law clearly stipulated "the change of land ownership and right to use of land take effective when the modification of registration is completed", but still insisted that Article 6 was a mandatory provision on administration.[84]

4. Formality Deficiencies

(56) Not all public law regulations intend to affect contract validity. If the law merely regulates the external orders of contracts, such as time, place, category and method, which are referred as formality regulations, the validity of contract will not be affected by violations of such law. (*see* para. 85–86),

(57) This is not because the violation of formality regulations "only harms the interests of the parties" but not harms "national interests or public interests" (*see* para. 27). On the contrary, such regulations often regulate public orders in abstract with no inquiries into individual interests of parties. For example, Article 28 of Regulations on the Administration of Entertainment Places provides that no entertainment place may operate between 2–8 a.m.. There is no doubt that it is a typical "mandatory provision on administration", where business conducted during that period would not be void and parties involved would not suffer from any damages. This regulation concerns about the peace and security in abstract social order, rather than the interests of specific par-

[84] 马维道与洛阳市瀍河回族区瀍河回族乡人民政府等确认合同无效纠纷申请案[Ma Weidao v. the People's Government of Luohe Huizu County on Retrial Disputes for Void Contract Determination](2014)豫法立二民申字第 00612 号, (Henan High People's Ct. Aug. 26 2014) CLI.C.3823727 CHINALAWINFO.

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ties. Therefore, even the mandatory provisions intend to protect "national or public interests", they may not necessarily serve as grounds for contract invalidity (*see* para. 29).

(58) A typical case involving formality deficiencies comes from Jilin High People's Court, which ruled that Clause 1, Article 26 of Environmental Protection Law, legal basis for environmental regulation department to supervise the construction projects' compliance with the national environmental protection standards …, merely prohibits the illegal constructions and operations of the legal person, but does not prohibit the contracting activities aiming to establish civil rights and/or obligations relations with others for project constructions. Therefore, this clause is a mandatory provision on administration instead of a mandatory provision on effectiveness subjected to Article 14 of Contract Interpretation Part II.[85] Besides, Article 64 of Law on Urban and Rural Planning[86], Clause 1, Article 17 of Seed Law[87], Article 7 of Administrative Regulations on Commercial Franchise Operations[88] are all regarded as mandatory provisions on administration for only regulates external orders.

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[85] 本溪市亚泰海绵铁炉料有限责任公司与吉林省杉松岗矿业集团靖宇天宇海绵铁有限公司租赁合同纠纷上诉案[Benxi Yatai Sponge Iron Furnace Co., Ltd. v. Jilin Province Shansonggang Mining Group Jingyu Tianyu Sponge Iron Co., Ltd. on Appeal Disputes over Lease Contract] (2014)吉民二终字第 65 号(Jilin High People's Ct. Aug. 18 2014) CLI.C.3299513 CHINALAWINFO

[86] Lin Jiafeng v. Youth Hostel, *Supra* note 51.

[87] *See* 松滋市宜食水稻种植专业合作社及松滋市金穗种子有限公司买卖合同纠纷案[Songzi Yishi Rice Planting Professional Cooperative v. Songzi Jinsui Seed Co., Ltd. on Sales Agreements Disputes](2015)鄂荆州中民三终字第 00114 号, (Hubei Jinzhou Interm. People's Ct. Aug. 12, 2015) CLI.C. 7023793 CHINALAWINFO.

[88] *See*《最高院关于不具备"拥有至少 2 个直营店且经营时间超过 1 年"的特许人所签订的特许经营合同是否有效的复函》[Reply on Whether Franchise Contracts Signed by Franchisor Who Do Not "own at least two direct sales stores that have been operating for more than one year" Are Valid],江门市蓬江区凤鸣餐饮管理有限公司与邓铭浩特许经营合同纠纷上诉案[Jiangmen Pengjiang Fengming Restaurant Management Co., Ltd. v. Deng Minghao on Appeal Disputes over Franchise Contracts] (2010)粤高法民三终字第 258 号, (Guangzhou High People's Ct. Sep. 13,2010) CLI.C. 349237 CHINALAWINFO; 贾建斌与重庆刘一手餐饮管理有限公司等特许经营合同纠纷上诉案(2011)[Jia Jianbin V. Chongqing Liu Yishou Restaurant Management Co., Ltd. et. al on Appeal Disputes over Franchises Contracts] (2011)渝高法民终字第 60 号 ,(Chongqing High People's Ct. Apr. 12,2011) CLI.C.825677 CHINALAWINFO;

伍永贤与柳州地下铁饮食管理有限公司特许经营合同纠纷上诉案[Wu Yongxian v. Liuzhou Underground Food Management Co., Ltd. on Appeal Disputes over Franchise Contracts] (2012)桂民三终字第 10 号,(Guangxi High

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(59) A case decided by Jiangsu High People's court[89] is more problematic. The court held that Clause 1, Article 31 of Administrative Measures for the Licensing of Catering Services (the prohibition of catering service license transfer) and Article 23 of Regulation on Individual Industrial and Commercial Households (the prohibition of business license transfer) were mandatory provisions on administration, thus, would not affect the validity of the restaurant transfer agreement. The catering service license, sanitation license and the business license can be regarded as related to the external order of operating a restaurant. But the reason why these provisions have no relevance with the validity of the transfer agreement is not their administrative nature, but that they do not intend to regulate the transfer of a restaurant. Therefore, the transfer of a restaurant is in no way violating these provisions.

(60) In fact, the ban on transfer of administrative license is a general requirement in Article 9 of Law on Administrative Licensing. This administrative provision is a mandatory provision on administration, but acts violating such provision should be void. Otherwise, parties can get around the mandatory provisions to obtain administrative license through private law transactions and the administration authorities will lose the absolute control over administrative licenses. The legitimacy of the absolute control is rooted in its close relationship with the social and public interests (Article 12 of Law on Administrative Licensing). In this sense, the ban on administrative license transfer is undoubtedly a mandatory provision on effectiveness. This is also the reason why most provisions on the market access qualifications are mandatory provisions on effectiveness. (*see* para 32–35)

5. Criminal Law Violations

(61) In addition to public law provisions, criminal law also falls within the referral scope of Article 52(5) of the Contract

People's Ct. June 8,2012) CLI.C.1200261 CHINALAWINFO; 苏海与武汉中醇化汽车新能源有限公司特许经营合同纠纷上诉案[Suhai v. Wuhan Zhongxing Automobile New Energy Co., Ltd. on Appeal Disputes over Franchise Contract] (2015)鄂民三终字第 00180 号, (Hubei High People's Ct. Apr. 30,2015) CLI.C.6741049 CHINALAWINFO.

89 何小平诉丁佐银确认合同无效纠纷案[He Xiaoping v. Ding Zuoyin on Disputes over Void Contract Determination](2015)苏审二民申字第 00020 号, (Jiangsu High People's Ct. Apr. 17,2015) CLI.C.7868108 CHINALAWINFO.

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Law. Here come a series of cases on criminal law violations. For example, the commission contract on murder is void because murder is prohibited by the criminal law.

(62) In judicial practice, a majority of cases involving criminal law violations under Article 52(5) of the Contract Law are about private lending. To address this issue, Article 13(1) of Provisions of the Supreme People's Court on Application of Laws to the Hearing of Private Lending Cases stipulated that, "if the lending activity between the borrower and the lender is suspected of any crime, or a valid verdict has found it a crime, the private lending contract is not necessarily void, when the party initiates civil proceedings. The validity of the private lending contract shall be determined by the People's Court according to Article 52 of the PRC Contract Law and Article 14 of these Provisions." The expression "not necessarily void" is unclear, but judiciary tends to maintain the validity of contracts. A typical case is the decision from Zhejiang Huzhou Intermediate People's Court[90], which has been published in the "People's Judiciary • Case" (Volume 22 of 2010) and the "Supreme People's Court Bulletin" (Volume 11 of 2011).

(63) The verdict held that the fact that the first defendant constituted the crime of illegally taking deposits from the public, "does not necessarily lead to invalidating the loan contract since the establishment of the loan agreement does not violate any mandatory provisions on effectiveness of law or administrative regulations." On this point, the trial court judge explained that "in this case, a single borrowing only formed a civil juristic relation of private lending, and does not constitute a criminal legal fact of illegally taking deposits from the public, because such criminal law fact requires an accumulation of borrowing from many non-specific persons."[91] The verdict did not invalidate a private law act based on the criminal offense. The attitude of "taking leniency on the validity of the private law acts" and "respecting parties' autonomy to the maximum extent" is commendable.

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[90] 王克祥等与吴国军等民间借贷纠纷案[Wu Kexiang etc. v. Wu Guojun etc. on Disputes over Private Lending](2009)浙湖商终字第 276 号, (Zhejiang Huzhou Interm. People's Ct. Aug. 2,2010) CLI.C.1539977 CHINALAWINFO.

[91] 沈芳君(Shen Fangjun), 构成非法吸收公众存款罪的民间借贷及其担保合同效力 [*Private Lending Constituting Illegally Taking Deposits from the Public and the Validity of Its Guarantee Contract*], 人民司法·案例 [PEOPLE'S JUDICIARY • CASES], Volume 22, at 81 (2010).

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However, since a single borrowing does not violate the criminal law, this case does not actually involve contract invalidity for criminal law violations under Article 52(5) of PRC Contract Law. If Article 176 of PRC Criminal Law never enters into the referral scope of the Contract Law Article 52(5), is it still relevant to similar cases?

(64) A possible inquiry into the aforementioned decision is why accumulation of borrowing is a crime while each single private borrowing is legal. Following the logic that each borrowing is targeted at a specific person, how does it satisfy the element of "non-specific persons" when it comes to several specific persons? Moreover, according to Article 3 of Interpretation of the Supreme People's Court of Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fund-raising, the number of depositors and the times of deposits are not necessarily the constructive elements of the crime.

When an alleged borrowing is deemed to constitute the crime of illegally taking deposits from the public, it at least shows that each borrowing shares its illegality to some degrees. Thus, the key of the problem may not lie in whether the depositors are specific or how many times they deposit, but whether the illegality of the borrowing behavior accumulates to the extent of criminal law violations. In other words, the borrowing behavior has already been illegal, before going through the criminal law as a second door triggering a crime. The first door is set by Article 4 of Measures for the Banning of Illegal Financial Institutions and Illegal Financial Business Operations (hereinafter referred as "Measures for the Banning"). Accordingly, the provision referred in PRC Contract Law Article 52(5) should be Article 4 of the Measures for the Banning. If the loan agreement is not invalid for violating Article 4 of Measures for the Banning, it only shows that Article 4 shall be interpreted as a mandatory provision on administration about formality (*see* para. 56). Article 4 of Measures for the Banning on no taking of deposit without the approval of the People's Bank of China seems to be a market access qualification regulation from appearance. But looking into the legislative intent, this provision does not prohibit the borrowing behavior itself, but merely providing loans in the role of financial institutions. Therefore, Article 4 is a formality deficiencies regulation on the way of behavior (*see* para. 85–86) rather

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than market access regulations (*see* para. 32–35). Therefore, banning such way of behavior is sufficient to realize the legislative intent and there is no need to touch upon the validity of making loans.

(65) In addition, civil-criminal cases involving agency are worth special attention. Unauthorized agency that is not subsequently ratified by the principal "has no effect on the principle" (Article 48 (1) of the Contract Law), but it is valid if constitutes apparent agency (Article 49, Article 50 of the Contract Law). Tibet High People's Court once ruled that when the agent constitutes the crime of forging a company seal, the contract chopped with the forged seal should be invalidated for violating Article 280 of Criminal Law as a mandatory provision on effectiveness.[92] The refusal to ratify is enough to achieve the legal result of "no effect on the principle". Therefore, emphasizing the contract is invalidated for committing the crime of forging a company seal is only to confirm that Article 280 of Criminal Law excludes apparent agency. However, a contract chopped with the forged company seal does not constitute apparent agency for the lack of principals' authority, regardless of crime constitution.[93] It is unnecessary to invalidate the contract by referring to Article 280 of Criminal Law through Article 52(5) of Contract Law.

(66) It is worth pointing out that the invalidity of a contract with the forged seal is subjected to further limitations and determinations. First, if the company ratifies the agency, it should have effect on the principal according to the converse interpretation of Article 48(1) of Contract Law. There is no conflict between the forger-agent bearing the criminal liabilities and the company bearing the contractual obligations, thus, the PRC Contract Law Article 52(5) does not apply. Second, if the company refuses to ratify the agency, the contract is not necessarily void. The language that the contract "has no effect on the principal" does not necessarily lead to the conclusion of contract invalidity. Bearing in mind the latter provision that "the actor shall be held liable", the actor may bear the obligation to perform a valid contract

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[92] 邹景权诉四川竞拓矿业投资有限公司等确认合同无效纠纷案[Zou Jingquan v. Sichuan Jingtuo Mining Investment Co., Ltd., etc. on Disputes over Void Contract Dertermination](2015)藏法民申字第 31 号裁定, Xizang High People's Ct, Jun. 15, 2015) CLI.C.6735024 CHINALAWINFO.

[93] *See supra* note 23, at 360.

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(unauthorized agency in bad faith), or a compensation responsibility of reliance interests for the void contract (unauthorized agency in good faith).[94]

6. Conclusion

(67) The dichotomy between mandatory provisions on effectiveness and mandatory provisions on administration established by the judicial interpretation is widely applied. However, the search results show that decisions in individual cases are not more satisfactory than the judicial interpretation itself. Apart from a few cases involving formality regulations (*see* para. 58), the majority of judicial decisions, under the guidance of such dichotomy, take a wrong way to find applicable law.

(70) Although the Guiding Opinion emphasized that a contract in violation of mandatory provisions on administration is not necessarily void or definitely valid, two cognitive tendencies are almost inevitable as demonstrated in judicial opinions once such dichotomy has dominated. First, provisions that are beyond the referral scope of Article 52(5) of the Contract Law are not mandatory provisions on effectiveness, and therefore belong to the type of mandatory provisions on administration. Second, if a contract violates only mandatory provisions on administration, the contract is valid accordingly. If this dichotomy is logically perfect, these decisions are also reasonable. But the problems are such dichotomy of mandatory provisions on effectiveness and mandatory provisions on administration cannot cover all kinds of mandatory provisions (*see* para. 17, 43) and mandatory provisions on administration may affect the validity of contracts as well. Such dichotomy is untenable with respect to logical and conceptual analysis. In fact, when the judicial interpretation drafter has already laid down potential problems for judicial decisions when on the one hand introduced Mr. Shi Shangkuan's theory about effective provisions and prohibitive provisions, but on the other hand ignored the scope of this theory and replaced "prohibitive provisions" with "mandatory provisions on administration".

[94] *See supra* note 23, at 351–52.

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D. The Logic of Thinking

(69) The Guiding Opinion confuses the mandatory provisions on administration with the "prohibitive provisions" referred to by Mr. Shi Shangkuan, in an attempt to show that this kind of provisions do not affect the validity of the contract because of its administration function (*see* para. 20). Admittedly, it would be helpful if the statement could provide more information, but the information added here lead to a logical mess, rather than assisting the illustration of the concept. It will be worth rethinking the renaming of the "prohibitive provisions."

(70) In terms of function, there is no reason to think that, mandatory provisions with administrative function cannot be effective provisions at the same time. When a mandatory provision is meant to affect the validity of contracts by setting a threshold to markets, it exactly means that the goal of "administration" must be achieved through affecting the validity of contracts. In order to formulate an opposite concept for the mandatory provisions on effectiveness, the judicial interpretations chose "administration." This behavior might include a deep thought to limit the administrative power, but it has failed to solve the problem. The consequence is that, the administrative power is not necessarily limited, but the judicial adjudication suffers at the same time.

(71) Additionally, Mr. Shi's definitions of effective provisions and prohibitive provisions are drawn from interpreting "legislative intent". If not invalidating the contracts would lead to frustration of the legislative intent, then the provisions are effective provisions, *vice versa*.[95] This indicate that in the logical reasoning, one need to draw the interpretation according to the consequences of violating mandatory provisions in the first place, and then decide whether the provisions are effective or prohibitive provisions.

The judicial interpretation of Contract Law limits the "mandatory provisions" in Article 52(5) as "mandatory provisions on effectiveness", and further replaces the "prohibitive provisions" with "mandatory provisions on administration" as the opposite to the "mandatory provisions on effectiveness". This is

[95] *See supra* note 38, at 300.

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sending a message that as long as judges decide that the mandatory provisions have administrative functions, they can categorize these mandatory provisions into mandatory provisions on administration and then denies them as effectiveness provisions. It can be summarized that within the dichotomy framework, nearly all judicial adjudications follow the same reasoning formula, namely, if the provisions are mandatory provisions on administration, they are not mandatory provisions on effectiveness and cannot invalidate the contracts.[96] In this regard, the logical process is to first decide whether the nature of provisions is mandatory provision on administration, and then draw the conclusion of violations' consequences. The logical flaw is reversed that the conclusion of interpretation becomes the precondition for the reasoning.

(72) Logically, once the mandatory provisions on administration, in place of "prohibitive provisions", become the precondition to contract validity, the opposite concept "mandatory provisions on effectiveness" change as well. Article 15 of the Guiding Opinion provides that "People's Court shall find the contract invalid for violating mandatory provisions on effectiveness". This article exactly shows the logical flaw of confusing cause and result, namely, that the reason why a contract is void lies in the violation of mandatory provisions on effectiveness. However, in fact, only the mandatory provisions that invalidate contracts can be regarded as mandatory provisions on effectiveness. Thus, a contract is void not for violating the mandatory provisions on effectiveness, but for the reason that a specific mandatory provision on effectiveness makes the contract void.[97] More precisely, in applying Article 52(5) of Contract Law, the question to be answered is: what are the mandatory provisions violated and on what grounds are the contract made void, instead of what the name of concept should be given to the provision

[96] In 黄春晚与成都艾玛企业管理有限公司等特许经营合同纠纷再审申请案 [Huang Chunwan v. Chengdu Emma Enterprise Management Co., Ltd. on Retrial Disputes over Franchises](2014)川民申字第 1658 号, (Sichuan High People 's Ct. Oct. 29, 2014) CLI.C.3830103 CHINALAWINFO, the court insisted the opinion that the reasons to terminate the contract is void since § 23.3 of Administrative Regulations on Commercial Franchise Operations is mandatory provisions on administration, in spite of such provision gives the right of rescission.

[97] See 黄忠(Huang Zhong), 违法合同的效力判定路径之辨识 [*Method to Analyze the Effectiveness of Contract against Mandatory Provisions*], 法学家 [JURIST], issue 5, at 67–68 (2010).

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after finding out the mandatory provision invalidating the contract. The categorization of mandatory provisions on effectiveness or administration should be addressed later as a result of legal interpretation. Thus, it shouldn't be a precondition to the reasoning in judicial application.

IV. IDENTIFY THE LEGISLATIVE INTENT OF PROHIBITIVE RULES

A. Introduction

(73) As indicated above, the dichotomy between "mandatory provisions on effectiveness" and "mandatory provisions on administration" is hardly tenable in terms of concept, logic and thinking approaches. Judicial adjudication limited by such dichotomy is also lack in quality. However, Article16 of the Guiding Opinion is not meaningless. It mentions the most important factor in determining the nature of provisions – "the purpose of laws and regulations". In other words, legislative intent is the standard to determine the nature of provisions. For instance, when a prohibitive rule does not specify the legal effect of violation, judges in deciding the effect of this rule on contract validity should ask whether the legislative intent would be frustrated if a contract violating the prohibitive rule is made valid. If the legislative intent is frustrated, the contract shall be invalidated. Otherwise, judges may as well let the contract take effect.

(74) In fact, the dichotomy has no binding effect on judges. As long as judges can realize that the dichotomy is the result of legal interpretation instead of preconditions to legal reasoning, they can interpret the legislative intent based on the regulation itself. Judges can make judgement through Article 52(5) of Contract Law as a referral provision if they invalidate the contract as a result of legislative intent interpretation. It means that the dichotomy makes no difference on the result of judgment no matter whether the judges know about the concept of "mandatory provisions on effectiveness" and "mandatory provisions on administration". Even if judges see a need to show respect to judicial interpretation, it is sufficient to adapt the analysis framework in Contract Law Interpretation II Article 14. Therefore, the key question is how to identify the legislative intent.

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B. Formal Determination

(75) Legal norms need to be expressed in words, and the legislative intent can also be interpreted from words. Fine wording could convey the information about the nature of prohibitions. In German Law, regulations on prohibition are mainly expressed in three ways, namely, "should not" (soll nicht), "not allowed" (darf nicht), and "can not" (kann nicht), which means mandatory provision, permissive provision and the opposite of authorization provision, respectively.[98] Legal effects of violating those rules are different. A juristic act is not void when it violates "should not" provisions. When it violates "not allowed" provisions, the validity depends on the legislative intent. But a juristic act is invalid if it goes against "can not" provisions.[99]

(76) The advantage of formalistic language distinction is clear and simple, but it has shortcomings as well.

First, formal determination is not realistic in China because it's too demanding for academic accomplishment of legislators and precision of legislative language.[100]

Second, too much emphasis on wording of prohibitive provisions might result in stringency or even neglecting the essentials, since the function of law is expressed substantially through legislative intent rather than outer forms. Take Article 181 of German Civil Code as an example. It provides that agents "can not" conduct self-representatives. Based on wording, self-representatives violate authorization provisions and therefore should be absolutely void.[101] However, the mainstream opinion in Germany holds that if such invalidation goes against the legislative intent, there should be more discretion in determining contract validity.[102]

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[98] *Supra* note 5, at 466 and following pages.

[99] *See* Schwab/Löhnig, Einführung in das Zivilrecht, 18. Aufl., 2010, Rn. 662. 梅仲协 (MEI ZHONGXIE), 民法要义 [THE ESSENTIALS OF CIVIL LAW], at 118 (China University of Political Science and Law Press, 1998).

[100] The Supreme People's Court has admitted this opinion. *See supra* note 47.

[101] Vgl. Brox/Walker, Allgemenier Teil des BGB, 34. Aufl., München: Vahlen, 2010, Rn. 586.

[102] *Id.*, *See* Rn. 586; Reinhard Bork, Allgemeiner Teil des Bürgerlichen Gesetzbuchs, 3. Aufl., 2011, Rn. 1600; Rüthers/Stadler, Allgemeiner Teil des BGB, 16. Aufl., 2009, § 30 Rn.56; Staudinger/Schilken (2004), § 181 Rn. 45.

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Furthermore, not all provisions on prohibitions contains negative words like "should not". Validity of a juristic act usually depends on the legal effect of the provision. For example, Article 232 (1) of Chinese Criminal Law stipulates that "whoever intentionally commits homicide shall be sentenced to death, life imprisonment or a fixed-term imprisonment of not less than 10 years". Even if there is no negative word in the provision, it apparently contains a provision of "prohibition on homicide".

Last, same words may have different legal effects from context to context. For instance, there are at least 6 usages of "should" in Contract Law: (1) in Article 5–8, "should" establishes abstract general obligations for parties, and the consequence of violations depend on other specific provisions; (2) in Article 14 and the first sentence of Article 30, "should" relates to elements of contract formation (expression of intent), the lack of which will render a contract unformed; (3) in Article 23(1) and 44 (2), "should" relates to elements of contract validity (expression of intent), the lack of which will render a contract invalid (Wirksamkeitsvoraussetzung); (4) in Article 9(1) and 10(2), "should" relates to conditions to the effectiveness of contract, the lack of which will render a contract defective in validity (Wirksamkeitshinderins); (5) in Article 42 and 43(2), "should" establishes specific obligations for parties to a contract; and (6) in Article 132(1), "should" has no impact on either contracts or parties.

C. Substantive Determination

1. Overview

(77) A more reliable standard is the substantive legislative intent, that is, the goal of regulation by prohibiting certain acts.[103] Therefore, abandoning the confusing dichotomy between "mandatory provisions on effectiveness" and "mandatory provisions on administration", and borrowing the German theory may be a feasible approach. Of course, no single theory can solve the problem once and for all because legal interpretation is always developed under specific provisions. Thus, there is no so-called

[103] *See* Larenz/Wolf, Allgemeiner Teil des Bürgerlichen Rechts, 9. Aufl., 2004, § 40 Rn. 10.

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deciding standard, but only factors to be considered in legal interpretation.

(78) Based on the goal of mandatory provisions, prohibitions are categorized into Content-Based Prohibition (Inhaltsverbote), Enforcement-Based Prohibition (Vornahmeverbote) and Pure-Formality Regulation (bloße Ordnungsvorschriften).

2. Content-Based Prohibition

(79) The Content-Based Prohibition is an absolute prohibition (absolute Verbote)[104], which prohibits the realization of parties' mutual consent or the legal consequence they pursued.[105] To make an agency agreement with killing somebody as the subject matter is an example of this type. A juristic act in violation of the Content-Based Prohibition is not valid, otherwise a paradox will arise: where on the one hand the asserted mutual consent is prohibited, but on the other hand the obligations provided by such consent should be actively performed.

(80) The Content-Based Prohibition generally regulates the obligatory contracts. Chinese scholars differ regarding its application to the real right contracts. However, when it comes to cases involving the Content-Based Prohibition, the abstract principle of juristic act of real right (abstraktionsprinzip) offers a reasonable solution.

Under the abstraction principle, generally the Content-Based Prohibition only invalidates the act of debt. The validity of the act of disposition (verfügungsgeschäft) as the act of performance, is unaffected because it is separated from the cause of the act, namely, the act of debt. In this case, only the benefit givers are entitled to the claim of restitution under unjust enrichment rule. For instance, a donation agreement with a purpose of bribery is invalid because it violates Criminal Law Article 385, but the act of payment transfer under the donation agreement could be valid. If the bribers are faultless, they can seek restitution according to Contract Law Article 58. And if the bribers are solicited to pay bribes, they could even request to invoke the act

[104] *See* Rüthers/Stadler, Allgemeiner Teil des BGB, 16. Aufl., 2009, § 26 Rn. 7 ff.

[105] *See* Reinhard Bork, Allgemeiner Teil des Bürgerlichen Gesetzbuchs, 3. Aufl., 2011, Rn. 1093.

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of transferring ownership when such requirement constitutes coercion (Article 54(2) of the Contract Law). They can further seek restitution as the title holders of the property pursuant to Art. 34 of the Property Law. If the bribees are subject to fines or confiscation for accepting the bribes under Article 383 of the Criminal Law, the faultless bribers enjoy the claim of restitution for unjust enrichment prior to confiscation of the bribes. (Fa Shi [2014] No.13 Several Provisions of the Supreme People's Court on the Enforcement of Property Involved in Criminal Judgments, Article 13.1, hereinafter "Provisions on the Enforcement of Property.") Or the faultless bribers can claim restitution of the property after the contract is revoked for coercion, in which situation the involved property will be deducted from the bribe amount and is not subject to confiscation (Article 9(1) of Provisions on the Enforcement of Property). However, only when the bribers are also at fault by themselves will the rights to restitution be removed and the bribes be confiscated. In this regard, distinguishing active bribery and passively paying bribes by extortion is not only reflected in Article 389 of the Criminal Law, but also echoed in civil law through the abstraction principle of juristic act of real right, which is indeed a proper practice.

On the contrary, if the act of disposition is regarded as to be caused by the act of debt or the independence of such disposition is denied, the nullification of the donation agreement will not transfer the ownership of the bribes. The bribers still retain the titles. When the bribees are sentenced to confiscation, the bribes could not be confiscated by law because the bribees have no title to them. In this situation, active bribers will enjoy improper privileges if they are allowed to claim restitution.

(81) Certainly, if the Content-Based Prohibition does not only prohibit the act of debt, but also rejects the benefits acquired, both the act of debt and the act of disposition should be invalid. In this regard, because the ownership does not change, the person who disposes the property should be entitled to restitution as the title holder of the property. For instance, Article 16(2) of the Administrative Regulations on Precursor Chemicals stipulates that "no individual may purchase any precursor chemical in Category I or II." According to the legislative intent of this clause, it does not only prohibit the formation of sales contract on chemical in Category I or II, but also prohibits attaining the titles

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of the purchased items. Therefore, neither the act of debt or the act of disposition is valid.

3. Enforcement-Based Prohibition

(82) Prohibitive provision that aim at the enforcement or performance of the acts, rather than the acts themselves, is termed as the Enforcement-Based Prohibition.[106] Mr. Shi Shangkuan defines the inherent prohibitive provision in a similar manner, as he states that the inherent prohibitive provision is focused on the factual behavior value of the prohibited acts, and aims at preventing these acts.[107] However, the legal effects under the two definitions are very different. Mr. Shi's inherent prohibitive provision only aims at deterring the acts, instead of invalidating them.[108] But the Enforcement-Based Prohibition under German law generally leads to the invalidation of the juristic acts.[109]

(83) Considering the similarity of the effects on the juristic acts, many German scholars propose to combine the Enforcement-Based Prohibition with the Content-Based Prohibition, and eliminate the distinctions between the two.[110] However, in Reinhard Bork's opinion, the Enforcement-Based Prohibition is different from the Content- Based Prohibition.[111] An act that violates the Enforcement-Based Prohibition is deemed invalid, not because of the inappropriateness of its contents, but is based on the unjust consequences arising out of the enforcement. For example, disposal of stolen goods is prohibited (Article 312 of the Criminal Law), because the subject matter here is obtained illegally, not because the transfer of goods or payment of consideration mutually assented by the two parties contradict the principle of justice. Furthermore, there is almost no exception to invalidating the juristic acts that violate the Content-Based Prohibition, while the acts that violate the Enforcement-Based Prohibition indeed have invalidity exception.[112]

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[106] *Id*, para. 1094.
[107] *See* SHI, *supra* note 38, at 330.
[108] *Id.*
[109] *See* BORK, *supra* note 105, para. 1115.
[110] *See* BROX & WALKER, *supra* note 101, para. 324; RÜTHERS & STADLER, *supra* note 104, § 26, para. 7.
[111] *See* BORK, *supra* note 105, para. 1094.
[112] *See* BORK, *supra* note 105, para. 1113, 1115.

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(84) The exceptions to the invalidity of the Enforcement-Based Prohibition include two different circumstances: unilateral prohibition and unilateral breach in a bilateral prohibition.[113] First, Article 148(1) of the Company Law is a typical example of the unilateral prohibition, which only regulates the directors and senior officers of companies. The counter party's act is not deemed invalid, even if the directors or the senior officers violate their fiduciary duty owed to the company. As prescribed in Article 148(2) of the Company Law, the company is entitled to the enrichment of the directors or senior officers. By contrast, some unilateral prohibition may lead to contract invalidity like the bilateral prohibition. One example of this kind is invalidity of a standard term that excludes the liabilities of a contract-offering party, increases the liabilities of the other, or deprives the other party of material rights, as stipulated in the second half section of Contract Law Article 40 as well as Article 24 of the Law on the Protection of Consumer Rights and Interests. Second, in a bilateral prohibition that regulates both parties, if only one party breaches its obligations, the validity of the contract will be either deemed positive or decided by the non-breaching party in good faith. For example, a sales contact made between a buyer in good faith and the seller who intends to disposal of stolen goods. However, for Content-Based Prohibition, no matter whether violation is unilateral or bilateral, the contract will be invalidated.

4. Pure-Formality Regulation

(85) The Pure-Formality Regulation regulates the external conditions of the juristic acts, such as time, location, categories and methods.[114] Because the formality regulation does not regulate the juristic acts *per se*, it shall be interpreted as a relative prohibition (relative Verbote) [115.] (*see* para. 57)

(86) The Pure-Formality Regulation is intended to create a safe and just environment for contracts. Parties who violate the Pure-Formality regulation shall receive administrative or even criminal penalties, while the validity of the contract is unaffected.

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[113] *See* BORK, *supra* note 105, para. 1116.

[114] *See* Laurenz & Wolf, supra note 103, § 40, para. 17; RÜTHERS & STADLER, *supra* note 104, § 26, para. 4; BORK, *supra* note 105, para. 1095.

[115] *See* RÜTHERS & STADLER, *supra* note 104, § 26, para. 4.

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Thus, the legal effect of the Pure-Formality Regulation is closer to that of the inherent prohibitive provision proposed by Mr. Shi Shangkuan. For instance, Article 28 of the Regulations on the Administration of Entertainment Places is a regulation on the mandatory restriction on the opening time of the entertainment places. Entertainment business operators will be subject to administrative penalties if they violate the restriction. However, the contracts involve operations during the restricted opening period is valid. (*see* para. 57)

(87) In judicial practice, the mandatory provisions on administration in pure formality category (*see* para. 56–58) could be classified in to the Pure Formality Regulation.

V. SYSTEMATIC NEXUS OF THE PROVISIONS

A. Art. 58.1(5) of the General Rules on the Civil Law

(88) The Article 58.1(5) of the General Rules on the Civil Law contain two sorts of regulations: invalidating juristic acts for violations of the law and for violations of public interests. Article 52(5) of the Contract Law is an updated version of the previous rule. If the two overlap in application, following the principle of "new rules apply for cases occurred after the new rules are issued and the old rules apply if the contrary," the applicable law should be the one that is effective when the act at issue was conducted.[116] Thus, the word "law" in Article 58.1(5) of the General Rules on the Civil Law should be interpreted narrowly to avoid confusions. (*see* para. 5–6)

(89) The opinion that new rule-Article 52(5) of the Contract Law has replaced the old one-Article 58.1(5) of the General Rules on the Civil Law is inaccurate. First, unilateral acts remain to be regulated by the General Rules on the Civil Law. Second, Article 2(2) of the Contract Law has excluded the application of Contract

[116] In 诸暨市兽药厂诉诸暨市地方税务局借款合同案[Zhuji Veterinary Drug Factory v. Zhuji Local Taxation Bureau on Appeal Dispute over Loan Agreement] (2007)绍中民二终字第 382 号, (Zhejiang Shaoxing Interm. People's Ct. Aug 23, 2007) CLI.C.235468 CHINALAWINFO, the Court affirmed that because the civil act at issue took place before the implementation of the Contract Law came into effect, the applicable law is the law effective at that specific moment, and that the judgment by the trial court incorrectly applied the Contract Law and should be amended.

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Law on agreements related to marriage, adoption, custody and other agreements on personal identities. If these agreements trigger any legal prohibitions, the General Rules on the Civil Law prevails.

(90) In addition, some judges chose to apply the General Rules on the Civil Law instead of the Contract Law for several special types of contracts, such as the equity transfer agreement[117], the trademark transfer agreement[118], the contract of inheritance[119] and so forth. However, except that the contract of inheritance could arguably be classified as agreement related to personal identities, it is not sufficiently reasonable to apply the General Rules on the Civil Law, instead of the Contract Law, on equity transfer agreement and trademark transfer agreement.

B. Art. 52(4) of the Contract Law

(91) The Article. 52(4) of the Contract Law corresponds to the latter situation in Article 58.1(5) of the General Rules on the Civil Law. The violation of law and the violation of public interests are listed separately and in parallel, suggesting the independence of the two individual basis for judgments.[120] The violation of public interests contains less certainty and grants more discretion than that of the law. Thus, judges should prioritize the provision on violation of law in judicial application. Only when there is no proper prohibitive rules and provision on violation of law is not applicable, could judges cite the provision on public

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[117] 苏州市金三角家具商场诉苏州工业园区清源环保运营工程有限公司、张杏弟股权转让案[Suzhou Golden Triangle Furniture Mall v. Suzhou Industrial Park Qingyuan Environmental Protection Operation Engineering Co., Ltd. and Zhang Xingdi's equity transfer case on Share Transfer Disputes] (2002)苏中民二终字第 348 号判决, (Jiangsu Suzhou Interm. People's Ct. Oct. 9, 2002) CLI.C.45556 CHINALAWINFO.

[118] 广州市康佰保健用品有限公司诉上海企玛科技开发有限公司等商标权转让合同案[Guangzhou Kangbai Health Products Co., Ltd. v. Shanghai Qima Technology Development Co., Ltd. et al. on Disputes over Trademarks Transfer Agreement](2005)二中民终字第 2980 号判决, (Beijing Second Interm. People's Ct. July 19, 2005) CLI.C.95375 CHINALAWINFO.

[119] 胡艳琼等诉胡艳红法定继承案[Hu Yanqiong et al. v. Hu Yanhong on Disputes over Legal Succession](2009)玉中民一终字第 57 号判决, (Yunnan Yuxi Interm. People's Ct. Feb. 23, 2009) CLI.C.353100 CHINALAWINFO.

[120] *See* HUANG, *supra* note 97, at 72 (some arguing that in essence the art. 52(5) could be incorporated by the art. 52(4), and thus the art. 52(5) itself is not an independent legal authority). *But see* HAN, *supra* note 35, at 15–18.

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interests to invalidate a contract.[121] In this sense, the provision on public interests are more proximate to legal principles, which can only be used when concreate rule is not available.[122]

VI. LEGAL EFFECTS

(92) Invalidity in Article 52(5) of the Contract Law means "no binding legal effect from the beginning" as in the former part of Article 56. On the one hand, contracts are invalid from the beginning of the contract formation for violating prohibitive rules; on the other hand, "no binding legal effect from the beginning" also means the effectiveness is determined, not pending (uncertain effectiveness). Also, such invalidity is beyond the scope of parties' autonomy (*see* para. 1) and can be determined by Judges *ex officio*, regardless of parties' assertions. The contract is void without any doubt.

It is unnecessary to discuss whether the mandatory provisions involved are "mandatory provisions on effectiveness" or not, if the legal acts involved are not void without any doubt, but pending for other defects on effectiveness. Some examples are revocable contracts (eg. Article 54(1) of the Contract Law) or effectiveness pending contracts (eg. Article 47(1), Article 48(1), Article 50 and Article 51 of the Contract Law) (*see* para.17).

(93) A contract can be partially invalid. According to the latter sentence in Contract Law Article 56, "if part of a contract is void without affecting the validity of the other parts, the other parts shall still be valid". Generally, there are two types of situations when partial validity has no effects on the overall validity of the contract:

One type is the void part is not significant. If the void part is not significant in a whole contract, the validity of other parts should not be affected. For example, parties entered into a lease agreement and created a right of preemptive on the house with absolute effects (effects of real rights). Such right of preemptive on the house (with the effects of real rights) are invalid for vio-

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[121] *See* HAN, *supra* note 35, at 17.

[122] Although the arrangement of regulations rarely affect the sequence applicable to the deal with a civil case, the Contract Law would appear more reasonable in form if the item 4 and 5 of the art. 52 are replaced with each other.

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lating Article 5 of PRC Property Law. However, the right of preemptive is generally insignificant to the establishment of lease agreement; thus, the validity of the contract is not affected, except that the tenement set the right of preemptive as a precondition to the lease agreement.

Another type is the void part is independent. If the void part is separable, the remain parts would not be affected regardless of significance of the void part. The independency is generally based on read of parties' intent. For example, Article 57 of the Contract Law provides that invalidity of a contract will not affect the validity of an independent dispute resolution provisions and *vice versa*. Recognizing the independence of dispute resolution provisions is consistent with what a reasonable person perceives about transactions, because the dispute resolution provision is not related to the material contents of a contract. Another example is Article 214 of the Contract Law, providing that when the term of a lease agreement exceeds 20 years, the exceeding part is invalid. "The exceeding part is invalid" because a reasonable person will not take an extreme position of "leasing all or not leasing at all" when signing a leasing contract for such a long term.

(94) In principle, contracts violating prohibitive rules are invalid to anyone (absolute invalidity). If a legal prohibitive rule is only made for protecting a certain group of people and it is sufficient to invalidate such contracts among the particular group, therefore, it is unnecessary to completely void the contracts as a whole. For example, the latter sentence of Article 20(1) in PRC Property Law provides that "after the advance notice registration, any disposal of the real property without obtaining the consent of the holder in the advance notice registration shall have no real right effect". The "shall have no real right effect" should be interpreted as no real right effect on the holder in the advance notice registration, namely, relative invalidity.

(95) When an obligatory contract is invalid, the obligor is relieved from performing the unperformed part of this contract, and the obligee has an obligation of return or compensations (Article 58 of Contract Law). When a real right contract is invalid, the transferor has a right to petition for return as the real right owner (Article 34 of Property Law).

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VII. BURDEN OF PROOF

(96) Party claiming the invalidity of contract for violations of the prohibitive rules bears the burden of proof. When a judge finds no such ground exists, he or she can also void this contract *ex officio*.

(97) In the case of partial invalidity, after proving contract's invalidity for violations of prohibitive rules, the burden of proof shifts to the party asserting that "remaining parts of the contract are valid." The content to be proved is that the invalid parts "do not affect the validity of other parts."

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The Empirical Study on the Invalidation of Illegal Contracts in China

YE Mingyi[*]

ABSTRACT

Empirical research indicates that, in the fields of invalidation of an illegal contract, the most commonly invalidated contracts [in China] are (housing) sales contracts, land usage rights (sell or transfer) contracts, construction contracts, (housing) rent contracts, land contracting contracts, and loan contracts. The most common contractual elements violating mandatory provisions are illegal subjects of contracts (qualification) and illegal objects of contracts. The most common mandatory provisions subject to such violations are those provisions related to the right to use collective land in rural areas, lacking construction qualifications, lacking credit loan qualifications, unregistered real estate, the disposition of illegal construction. In practice, mandatory provisions are commonly misread and inconsistently determined, especially in contracts involving unauthorized disposition, transfer of unregistered real estate or houses built on rural homestead, contracts signed by parties without qualifications, contracts where one party involved in economic crimes. To improve the regime of contractual invalidation in China, we should legalize the reference of mandatory provisions, adopt a uniform criterion [in identifying mandatory provisions], narrow down the scope of application, and separate the civil and criminal trial practices.

Key words: *Violation of Law, Contract, Invalidation, Mandatory Provisions, Empirical Research*

[*] YE Mingyi (1979–), male, from Anhui Chaohu, Associate Professor of the Civil and Commercial Law School of the Northwest University of Politics and Law, Doctor of Law. The author is thankful for the precious advice on the initial draft from Dr. PENG Xiaolong of Renmin University of China. This translation was produced by ZHU Liusheng, WEN Shuke, and WANG Menglan from Peking University School of Transnational Law.

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I. INTRODUCTION

In recent decades, there has been a rising trend in the academia discussing the validity of contracts in violation of mandatory legal norms reading together with Article 52(5) of the PRC Contract Law. A number of important treatises have been authored. [1] These treatises have made constructive explorations on the identification of mandatory provisions on validity. However, there is no systemic study on the application of this provision [Article 52(5)] in our judicial practice. As the law is a practical science, the study of "is" should take precedence over "ought to be" in legal study. In particular, China is now undergoing an unprecedented reform and transformation. The legal practice in this process has a unique "Chinese element." It then becomes pressing to identify the real problem and ascertaining the operation of legal rules in the practice. Ten years after the promulgation of Chinese Contract Law, what is the enforcement status quo, what are the problems, and how do we respond? To answer these questions, we will conduct an empirical study on the classical cases that applied Article 52(5). Based on the comparative law experience, we will evaluate the practice of the invalidation of an illegal contract, and then put forward relevant improving suggestions.

II. THE STATISTICAL ANALYSIS OF EMPIRICAL DATA

A. Research Method

This article conducted statistical gathering and analysis of firsthand court case materials, aiming at revealing the judicial practice in the invalidation of illegal contracts and providing a basis for the theoretical construction and policy proposals.

We have gone through four sample databases. The first database is maintained by PKU Law, and we used "People's Republic of China Contract Law, Article 52 Section 5" as the search term. The time last researched was on April 22, 2014. We have collected 70 cases. Nine cases reached final judgments holding that

[1] The related important works include: Geng Lin: Mandatory Provisions and Contract Effectiveness, China Democracy and Law Press, 2009); Zhong Ruidong: The Mandatory Regulations in the Civil Law, Law Press, 2009); Huang Zhong: The Illegal Contract Effectiveness Theory, Law Press, 2010); Xu Zhongyuan: Studies of Civil Law Mandatory Provisions, Law Press, 2010.

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there was a valid contract, and we excluded them from the data analysis tables below. Hence, there are 61 valid samples in the final table.

The second database is an internal database maintained by the Shanghai court system. The researched time span is "cases concluded in 2010," the court is restricted to "Shanghai Intermediate Court and Shanghai High court." The search terms is the same, and produced 57 cases. Among them, there are four cases where the contract was held valid, and two cases where the contract was invalidated on other grounds.[2] There is one ruling to overrule the petition for civil re-trial. Hence, there are 50 valid samples in the final.

The research setting of the third sample is the same as the second sample, except that we set the scope to "cases concluded in 2011." There are 59 cases in the search results. Among the verdict, there are nine cases that the contract is valid, and two cases that is substantially based on other grounds for invalidation. Hence, there are 48 valid samples in the final.

The fourth sample database comes from the judicial case database of the PKU Lawyee. The searched period is on or before April 31, 2014. We first click on "category navigation", and then click by sequence "civil dispute—contract dispute—contract validity dispute—ascertaining invalid contract." There are 2,400 judgments downloaded, 353 incomplete judgments, and 2,047 complete judgments. Among them, there are 77 settled cases, and 155 dropped cases, 515 cases dismissed (including lack of evidence, plaintiff's lack of standing, barred by the statute of limitation, and lack of jurisdiction). There are 847 cases that involved the violation of section (1) to (4) of Article 52 of Chinese Contract Law. Namely, there are 453 judgments that involved Article 52(5) of the PRC Contract Law, including 98 judgments that ruled contract as valid, and 355 judgments ruled invalid.

Hence, there are 355 final valid data.

[2] The reference numbers of these two judgments are respectively "(2010) Huerzhong Miner (Min) Zhongzi No.551" and "(2010) Huyizhong Miner (Min) Zhongzi No.2879." These two cases all fall into the circumstance where it is the unauthorized agency in housing transaction that leads the invalidation of the contract.

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In summary, this article has examined 2,586 judgments, and there are 514 judgments listed as valid judgments. Admittedly, this essay has not delved into all 2,500 cases, but this research method can roughly reveal the overall features of judicial practice in light of the lack of judicial documents available on the Internet. There are, however, several limitations [of this article]: First, several provinces are missing from the sample, rendering the sample not perfectly represented. Second, because of separation of the cause of action in judicial practice, most of the cases in the sample are civil, and there are rarely some commercial cases. Third, some judgments are not well-reasoned, and sometimes don't even reveal the specific information referred by Article 52(5), posing troubles to the study. Fourth, in the civil and criminal cases, the cases that involved contractual validity was often directly dismissed by the court, and would never enter into the substantive trial stage. Listing this kind of cases into the sample should be redeemed in other aspects.

B. Overall Data

As can be seen from Table 1, our study has sampled cases from 21 provinces. These cases cover a broad range of regions. Some are in Guangdong, Fujian and other southern provinces in China, some in Xinjiang, Gansu and other northwestern regions, some in Jiangsu, Zhejiang and other East China provinces, some in Hunan and other central region, as well as some in Beijing, Tianjin and other regions in Northern China. In addition, there are thirteen provinces where the number of cases have reached double digits, of which 111 cases are in Henan Province. This shows that the sample case is quite representative. Judging from the trial level of the judgment, among the total of 416 cases, there are 275 cases where the first instance verdict was made by the basic-level or intermediate, and 137 cases where the second instance verdict was made by the intermediate Court or the High Court, and 4 cases of retrial judgment made by the intermediate or high court. This shows that the trial on the invalidity of the illegal contract is mainly carried out by the basic level court or the intermediate court, and the appeal rate is not low.

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TABLE 1: THE PROVINCIAL DISTRIBUTION AND TRIAL LEVEL OF SAMPLE 1 AND 4

	Yun—nan	Si-chuan	Fu-jian	Guang dong	Xin-jiang	Gan-su	He-nan	Hu-nan	Bei-jing	Jiang-su	Zhe-jiang	Shang-hai	Hu bei	Chong qing	An-Hui	Guang-xi	Shan-xi	He-Bei	Hai-nan	Hei-long-jiang	Tian-jin
Trial of First Instance	4	4	7	7	4	15	89	23	3	22	19	10	6	13	9	22	8	4	4	1	1
Trial of Second Instance	1	2	7	12	2	2	21	8	6	16	18	15	7	7	3	6	2	1		1	
Re-trial				1			1				1					1					

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TABLE 2：THE COURT AND THE TRIAL LEVEL OF SAMPLE 2 AND 3

	Sample 2 (2010)		Sample 3 (2011)	
	Intermediate Court	High Court	Intermediate Court	High Court
Trial of the First Instance	10		3	
Trial of the Second Instance	38	2	42	1
Re-trial			2	
In total	50		48	

Table 2 shows the court and the trial level of Sample 2 and Sample 3. It clearly shows that the predominant majority of the invalid contract cases was made by the Intermediate People's Court. There are only a few invalid cases made by the High People's Court.

TABLE 3: THE RATIO OF "INVALID CONTRACT" JUDGMENTS IN ALL JUDGMENTS THAT INVOKED ARTICLE 52(5)

	Sample 1	Sample 2	Sample 3	Sample 4
Valid	9	4	9	98
Invalid	61	50	48	355
The ratio that "invalid" accounted for the total	87.1%	92.6%	84.2%	78.4%

As can be seen from Table 3, in all the judgments that invoked Article 52 (5), the four sample groups all have judgments which ruled the contract to be valid; Furthermore, there are no obvious differences in terms of the "invalid" ratio [among sample groups]. The range varies from 78% to 92%, showing a relatively high "ratio of invalidity."

However, it is important to note that by analyzing the contents of the invalidation cases, we can find that in the majority of cases that invalidated the contracts, there is no disagreement on whether the parties violated mandatory provisionsand thereby rendered the contract invalid.[3] But in the small number of cases

[3] In cases where the contract was ultimately invalidated, contracting parties, at many times, had some knowledge over the invalidity of the contract, like the

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that invoked Article 52(5) but still ruled the contract to be valid, whether the contract violates the mandatory legal provisions often become a disputed issue of both sides, as the later described case where the education training contracts signed by person lack of vocational education qualifications. Therefore, the discussion of the second part of this article is not limited to cases where the contract is ultimately invalidated.

C. Types of Contract Involved

The abscissa of Table 4 is the type of illegal contract, and the ordinate is the sample bank. It can be seen from Table 4 that there are extensive types of contracts involved in contract invalidation, more than twenty of them. [4] At the same time, the concentrative characteristics of the contract type are also significant. In the total of 514 cases that invalidated the contract, the number of cases in (housing) sales contract, land use right (sell or transfer) contract, construction contract, (housing) lease contract, land contract and loan contract are respectively 126, 99, 59, 52, 50, and 46. The numbers of these types contract are in the top six, and are far ahead of other types of contracts. The total sum of these contracts is 432, accounting for 84% of all cases, constituting most of the sample cases.

borrowing and lending between corporations, the purchase of limited property house by urban citizens. Therefore, once the suit was crystalized, there will likely to be no substantive arguments over the valid conclusion of the contract. But this doesn't mean that this kind of case has no analytical value.

[4] There are 4 "Other" in Sample 1, including one book publishing contract, one brokerage contract, two stock trading contract, one in Sample 2, including one deposit-taking contract., 10 in Sample 4, including one stock trading contract, one deposit-taking contract, one mountain border contract, three inheritance division contracts, four voucher contract.

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TABLE 4: THE TYPE OF INVALIDATED ILLEGAL CONTRACT

	Sales Contract	Share Ownership Transfer Contract	Operation Authority Transfer Agreement	Lending Contract	Construction Contract	Processing Contract	Brokerage Contract	Education Training Contract	Renting Contract	Commission Contract	Land Contracts	Land Usage Contract	Resettlement Contract	Joint Ownership Contract	Medical Cooperation Contract	Other	Total
Sample 1	15	2	3	8	16	1			7		1	2		1	1	4	61
Sample 2	8			16	10		3	1	9	1			1			1	50
Sample 3	8			6	9		1	7	12	2		3					48
Sample 4	95	11	12	16	24	3	1	1	24	4	49	94	6	4	1	10	355
Total	126	13	15	46	59	4	5	9	52	7	50	99	7	5	2	15	514

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An overall comparison of the four samples shows that in terms of the concentration ration of the type of contract, four samples showed a more obvious common characteristic. That is, it is basically these kinds of contract that occupied the leading types of contract invalidation case.[5]

However, this conclusion requires further demonstration, because this result likely occurred in that these contracts happened more frequently in our daily lives, thus had a larger base. In order to rule out the influence of this factor, this paper also made a supplementary sampling analysis. That is, to gather data on the ratio of invalidity of common contracts. To this end, this article also used PKU law database as the search source. Using January 1, 2010 to December 31, 2011 as the time range, we conducted statistical analysis of the ratio of invalidity of common type of contract. The results are as follows.

TABLE 5: RATIO OF INVALIDITY OF TYPICAL CONTRACT

Type of Contract	Total Case Number	Violations of Article 52(5)	Ratio
Construction Contract	2258	5	0.221%
Rental Contract	3733	6	0.161%
Sales Contract	4216	5	0.118%
Processing Contract	1580	1	0.063%
Lending Contract	16338	1	0.006%

As shown in Table 5, the ratios of invalidity of construction project contracts, housing leasing contracts, housing sales contracts, loan contracts are in the forefront. It can be seen that the four types of contracts have not only a high number of invalid judgments, but also the highest ratio of invalidity of these four types of contracts. Therefore, the conclusion that invalid contract occurred in construction contracts, housing leasing, housing transactions, loan contracts. This conclusion can entirely be established.

[5] Land contracting contract and Land use rights contract are rare in the database of Sample 2 and 3. This shows that although the overall amounts of this type of case is high, the local characteristics remains extremely strong.

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D. The Contractual Elements of the Illegality: Form or Procedure, Subject, Subject or Purpose

Using contractual elements as the criteria, contract invalidation can be divided into the contract-making form or procedural invalidation, the contractual subject invalidation, the contractual object invalidation and the contractual object invalidation.

The contract-making procedure means to enter into a contract before the implementation of the relevant procedures, such as signing a contract without bidding; Illegal contract form means that the final contract did not adopt the statutory form, and is ultimately invalid.[6] Illegal contract subject means the lack of the legal qualification of the contractual party. Illegal contract object includes consensus invalidation or implementation invalidation. Illegal contractual purpose means the decisive motive of concluding the contract is illegal.

TABLE 6: THE ELEMENTS OF ILLEGAL CONTRACT

	Contractual form or proceeding	Contract subject (un qualified)	Contractual subject	Contractual goal	In total
Sample 1	7	26	22	6	61
Sample 2	4	30	15	1	50
Sample 3	2	22	23	1	48
Sample 4	44	175	120	16	355
In Total	57	253	180	24	514

Table 6 shows the macro-characteristics of the four samples' contract elements invalidation. In general, the contractual subject invalidation (The lack of legal qualification) is the most

[6] In this article' samples, no contract was invalidated because of the formal illegality in the narrow sense. Some scholars believe that the contract with legal norms for "advocacy norms." See Wang Yi, the standard configuration of civil code: -- to specification configuration of reflection on the < contract law > in China as the center ", published on the "journal of yantai university, 2005, p. 277. Judging from comparative law, French law exists a situation where contract was invalidated in the absolute sense because of the illegal form; V. J. Flour, J-L. Aubert et E. Savaux, Les obligations, Tome I: L'acte juridique, 14éd, Sirey, 2010, nº 269, p. 248; But Article 125 of the German Civil Codedid not specify that the legal action that didn't adopt the legal form is invalid. Of course, this kind of invalidity (Formnichtigkeit) is different from the validity in Article 134 Vgl. Armbrüster, Münchener Kommentar zum BGB, 5. Auflage 2006, BGB Article 134, Rn.112.

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common type, occupying 253 cases among 514 cases; With 180 cases, contractual object invalidation is in the second; Contractual form or contract procedures invalidation is relatively few, and have only 57 cases and 24 cases.

Not only is this case with the macro-characteristics. Comparing the four sample groups, we can see that the frequency of contractual elements invalidation occurred in a highly similar manner, and is also consistent with the overall ranking. The mutual corroboration [of data] shows that the ranking of the illegal contractual elements' occurrence rate identified in Table 6 is universal and representative.

Through the analysis of these judgments, we can find the basic situation of various illegal elements: First, for invalidation based on the subjects of contracts, the main scenario is that the qualification of the construction contract and the qualification of the lender in the loan contract is inconsistent with legal requirements. In addition, it also involves the qualification of the futures brokerage institution, the qualification of the real estate brokerage institution, the qualification of the performing arts broker, book publishing qualification, building materials selling qualification, printing processing business qualifications, medical qualifications, education training qualifications, special equipment production and sales qualification, storage qualifications, and so on.

Second, for invalidation based on the objects of contracts, property cases with no legal ownership certificates and under the collective land use rights that are in principle forbidden to be traded are among the two highest cases. In addition, other circumstances of the contractual object invalidation include: transfer of the joint-owned property of the husband and wife, the transfer of the business license, the transfer of the approval number of the drug, the overdraft of the securities, the provident fund loan, the guarantee clause of the joint venture contract, the sale of the fake liquor, and lawyer's private acceptance of representation.

Third, invalidation due to contract-making procedure includes unauthorized re-contracting of land contracting rights, unapproved aquatic project, unapproved sale of state-owned, foreign-related borrowing that fails registration procedures, signing the construction contract without the bidding process, the tenant's unauthorized re-rent of the housing.

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Fourth, invalidation based on purposes of contracts mostly concern small-scale and dispersed cases. The type of cases mainly include bank lending only for customers to stock, buy cemetery for the construction of the family cemetery, leasing game player only to provide gambling business, and tax evasion contract.

Judging from the courts' judgments, the vast majority of difficult cases in practice occurred also in the areas of illegal objects and subjects of contracts. These two aspects will be the focus of later discussion.

E. The Characteristics of the Violated Mandatory Provisions

Table 7 provides a direct answer to which mandatory provisions are violated by the contractual and elements, and what are the general characteristics of these regulations.[7]

[7] For clarity of the table, some of the name of the law and judicial interpretation used the simplified version. Besides, there exists an extensive overlap between the economic law and administrative law's categorization. The distinction of economic law and administrative in table 7 didn't observe the strict standard. The financial regulations are all put under the name of commercial and economic law.

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TABLE 7: FOUR SETS OF OVERALL DATA

Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
Relevant Contract Law Judicial Interpretation	1. Article 1 sections 1 and 2, Articles 2 and 7 (For Construction Law Articles 12, 13, 14, and Article 3 section 3 of the Tendering and Bidding Law) of the Construction Contract in Construction Project Judicial Interpretation.	3	47	1	1
	2. Article 4 section 1 of the Answers to Several Questions on Trying Joint-Ownership Case		1	2	
	3. Articles 2, 5, 9, and 16 of the Judicial Interpretation of Urban Housing Rental Contract	4		28	
	4. Article 8 of the Interpretation on Several Questions of Applying Guarantee Law		2	1	
	5. Article 2 of the Judicial Interpretation on Commercial Housing Sales Contract		3		
	6. Article 11 of the Interpretation on the Application Legal Problems of State-Owned Land Usage Contract	1		1	

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	7. Article 26 sections 1 and 2 and Article 32 of Provisions of the Supreme People's Court for the People's Courts to Seal up, Distrain and Freeze Properties in Civil Enforcement			1	
Civil Law	8. Article 55 of General Principles of the Civil Law		1		
	9. Articles 7, 9, 44, 48, 51, 52, 54, 56, 58, 59, 132, and 229 of the Contract Law	3	8	5	
	10. Articles 4, 7, 64, 76, 95, 97, 106, 115, 147, 153, 184, 186 and 187 of the Property Law	3	9	2	2
	11. Articles 5, 34, 37, 40 of the Guarantee Law	1	2	2	1
	12. Article 25 of the Inheritance Law, Article 60 of the Opinions of Several Questions on Inheritance Law.		1		
	13. Article 17 section 2 of the Marriage Law		3		
Commercial Law and	14. Article 2 of the Measures for Investigating, Punishing and Banning Unlicensed Business Operations	1	3		

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
Economic Law	15. Article 16 section 2, Article 72, Article 104, Article 141, Article 149 of the Company Law.	2	3		
	16. Article 54 of Regulation of the People's Republic of China on the Administration of Company Registration; Article 18 of Law of the Administration of Tax		1	1	
	17. Articles 2, 5, 20, 24, 61, 71 of the General Principles on Loan		41		1
	18. Urban State-Owed Housing Administrative Regulation	1			
	19. Article 13 of the Urban Real Estate Intermediary Administrative Regulation		1	2	1
	20. Article 34 section 2, Article 35, Article 37 section 2 and Article 6, Article 38, Article 39, Article 40 of the Urban Real Estate Administrative Measure	7	19	34	1
	21. Article 6 section 2 of Several Opinions on Strengthening Agricultural Basis Construction and Further Promote Agricultural Development and Farmer' Income		1		

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	22. Articles 16, 43, 125, 145, 132, 133, and 141 section 2 of Security Law		11	3	1
	23. Articles 53 and 55 of Law on the State-Owned Assets of Enterprises	2			
	24. Articles 6 and 7 of the Auction Law			1	
	25. Article 16 section 1 of the Consumer Protection Law, Articles 33, 40 sections 1 and 2 of the Product Quality Law			1	
	26. Articles 16, Article 18 section 1, and Article 20 of the Regulation on Foreign Currency Exchange	5			
	27. Articles 13, Article 26 section 2, and Article 29 section 3 of the Construction Law		8		
	28. Article 17 of the Regulation on the Administration of Futures Trading		4		
	29. Article 11 of the Commercial Bank Law		1		
	30. Article 23 section 3 of the Circular Economy Promotion Law				1
	31. Article 12 of the Price Law			1	
	32. Article 13 and 14 of the Anti-Monopoly Law			2	2

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	33. Article 4 of the Regulation on the Administration of Commercial Franchises		1		
	34. Article 16, Article 61 section 1 clause 9, Article 109, Article 111 section 2, and Article 112 section 1 of the Bankruptcy Law	1	1	2	2
	35. Article 4 of the Chinese Foreign Joint Venture Enterprise Law, Article 20 of the Regulation on the Implementation on Chinese-Foreign Equity Joint Ventures	1			
	36. Measures for Banning Illegal Financial Institutions and Illegal Financial Business Activities			1	
	37. Article 3 section 3, Article 6 section 1, Article 42 section 1 of the Mineral Resource Law		3	1	1
	38. Measures for the Administration of Transfer of Mineral Exploration Right and Mining Right			1	
	39. Article 2 section 3, Article 8 section 2, Articles 10, 12, 15, 32, 36 section 2, 43, 44, 48, 62, and 63 of the Land Management Law. Article 2 of the	8	53	53	5

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	Notification On Strengthening Land Transfer And Banning Land Speculation, and Article 10 of The State Council's Decisions on Deepening Reform Strict Land Management				
	40. Articles 3, 4 section 2, 5, 8 section 1, 9, 12, 18, 19, 20, 26 section 1, 32, 33, 34, 37 section 1, 41, 42, 44, 46, and 48 of the Rural Land Contract Law, Article 6 section 1 of the Interpretations of The Supreme People's Court about the Issues Concerning the Laws Applicable to the Trial of Cases of Disputes over Rural Land Contracting	6	9	22	1
Administrative Law	41. Article 35 section 5 of the Regulation on the Administration of Publication		1		
	42. Article 17 of the Non-State Education Promotion Law		2		
	43. Article 24 of the Regulation on Medical Organization, Articles 13 and 14 section 2 of the Practicing Physicians Law		2		
	44. Article 9 of the Regulations on the Administration of Funeral and Interment				1
	45. Article 23 of Regulations on the Administration			1	

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	of Construction Project Environmental Protection				
	46. Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas	1			
	47. Article 2 section 5 of the Regulation on the Implementation of the Land Administration Law		1		
	48. Article 39 section 1 of the Water Law, Article 25 of the Regulation of on the Administration of River Courses		2		
	49. Article 25 of Regulations of the Administration of Traffic Safety in Inland Rivers	1			
	50. Article 7 section 1 and Article 8 section 2 of the Pharmaceutical Administration Law			2	
	51. Article 12 of the Measures for the Administration of Pharmaceutical Trade License			2	
	52. Article 5 of the Regulation on the Administration of Housing Accumulation Funds			1	
	53. Articles 3, 4, and 10 of the Regulation on the Dismantlement of Urban Houses		2	2	

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	54. Article 14 of the Regulations on Safety Supervision of Special Equipment		1		
	55. Article 14 of Regulation on the Administration of Entertainment Venues				1
	56. Article 7 of the Regulation on the Administration of Commercial Performances		1		
	57. Article 40 of the Lawyers Law			1	
	58. Article 10 of the Organic Law of the Urban Residents Committee	1			
	59. Articles 17, 19, 24, and 28 of the Organic Law of the Villagers' Committees	3	2	1	
	60. Articles 9 and 80 of Administrative Licensing Law		1	2	
	61. Articles 10, 11, and 12 of the Regulations on the Administration of Business Premises of Internet Access Service		1		
	62. Interim Regulation on the controlling the numbers of Mini-Van in Beijing[8]				1

[8] See *Zhangyongqing v. Beijing Xinguolidu Transportation Corporation*. The reference number is (2013) Daming Chuzi No.6549

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Violated laws		Contract Making Procedure	Contractual Subject	Contractual Object	Contractual Purpose
	63. Article 5 section 2, Article 18 of the Regulations on Restoring Farmland to Forest	1		1	
Total	513（1）[9]	56（1）	253	181	23

[9] "(1)" involves Shen Yaozhang and Shanghai Baoyao Wukuang Trade Development Corporation v. Hou Yunkang. The mandatory provision violated in this case (the transfer of stock ownership requires approval from relevant authorities) was actually Nigeria mandatory provisions and cannot be included to this table.

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1. Macro Analysis

As can be seen from Table 7, a total of 63 laws, regulations or judicial interpretation is violated.[10] Judging from the number of provisions being violated, there are 25 kinds of commercial law and regulations that regulate the national economic order, from the company, foreign exchange to real estate. There is a wide range of rules. There are also as many as 25 kinds of rules that involve land management, qualification, behavior prohibition and other administrative rules on administrative relations. Civil laws and regulations and judicial interpretation that regulate special contract are the least types.

Judging from the frequency of violations of a single legal provision, the number of cases involving the Land Management Law are the largest (The illegal contractual subject and the illegal contract object accounted for 53 cases each); "On The Construction Of Construction Contract Disputes Applicable To The Interpretation Of Legal Issues" and rules involve construction qualification and contract conclusion and bidding procedure came the second (47 cases); There are 41 cases where the contract is in violation of the provisions of Article 61 of the Loan General Provisions on the prohibition of inter-bank borrowing between enterprises. These types of cases are ranked in the third.[11] The cases involve the house with unregistered ownership certificate, lack of co-owners' written consent, and the prohibition on transfer of the "Measures for the Administration of Urban Real Estate" came the fourth (34 cases); There are 28 cases involved in illegal construction of urban housing leasing contract invalid provisions of "On the Trial of Urban Housing Lease Contract Disputes in the Specific Application of a Number of Issues Related to the Interpretation of the Law," with the number of these cases ranked fifth; There are 22 violations of the "Rural Land Contract Law," with

[10] The mandatory rules mentioned in Article 52 (5) has a hierarchical restrain. In its technical sense, it is limited to law and administrative regulation. It appears to not include judicial interpretation. But judicial interpretation actually is a source of law with absolute authority. See Han Shiyuan: The General Theory of Contract Law, Law Press 2011, p17.

[11] Although the General Principles on Loan is only departmental rules, but through the "transformation" of the judicial interpretation in "The Response on Handling the Late Return of Loan in the Corporate Lending Contract", it can also be regarded as a mandatory rule in Article 52(5).

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the number of cases ranked sixth. These laws and regulations should be the focus of theoretical research.

2. Economic Public Order and Political Public Order

As can be seen from the sample data, the major legal areas of the invalidation of the illegal contract lie in commercial law, economic law and administrative law. First of all, when the state economic system or economic policy—that is the mandatory economic public order [12] —is challenged and disturbed by the contract, such contracts must be determined to be invalid. In the sample, the laws and regulations that involve the mandatory economic public order is very broad, including, for land housing, "Land Management Law", "Urban Real Estate Intermediary Management Regulations", "Urban Real Estate Management Approach"; for financial aspects, "Commercial Bank Law" , "General Principles of Loans", "State-owned Assets Law", "Foreign Exchange Administration Regulations", "Securities Law", "Futures Trading Management Regulations", "Tax Collection Management Law", "Price Law", "Company Registration Management Regulations" "Measures for Eradicate Unlicensed Operation"; The norms that regulates the market economic activity order, "Consumer Rights Protection Law", "Product Quality law", "Auction Law" and so on. Overall, the current mandatory economic public order is too wide, leading to the ratio of the invalid contract being too high.

Secondly, in addition to the above public economic order, there is even more ancient public political order. It involves the basic political system, social and cultural system, public security order and the protection of basic rights and other classical public order. The political public order is mainly stipulated in the constitution, criminal law, and administrative law. In this data sample, it is mainly reflected in the provisions of the administrative law.

As can be seen from Table 7, the administrative regulations involved in the data samples of this article mainly include the

[12] Mandatory economic public orders are the economic public orders that are formed when the government directs the contractual behaviors in order to maximize the social utility. It is a relative concept to the idea of "protective economic orders" which is intended to protect the weak side of the contract. See M Salah, Les transformations de l'ordre public économique, Vers un ordre public régulatoire, Mélanges G. Farjat, 1999, p. 261.

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aspects of education, science, culture, health, sports, civil, industry management and other various aspects, such as the Regulations on the Administration of Entertainment Places, the Law on the Promotion of Private Education of the People's Republic of China, Regulations on Management Regulations, Regulations on the Administration of the Regulations on the Administration of the People's Republic of China, the Regulations on the Administration of the Provident Funds, the Regulations on the Administration of Funeral and Funerals, the Regulations on the Supervision of Special Equipment and the Law on Lawyers. Overall, the vast majority of mandatory provisions in administrative law involve the practice or business qualifications, that is the violation of the administrative license of the legal rules; There are only a few that relate to the contract subject, purpose or its concluding procedures.

In summary, the invalidation of an illegal contract, in practice, lies mainly in the violation of the economic law and administrative law. Taking into account the economic law that provides the mandatory public economic order, it can be fully included in the scope of the general administrative law. Therefore, the violation of administrative law is the most important situation of contract invalidity. This also confirms the Chinese scholar's assertion that the "the convergence of administrative law and civil law is of highly technical and difficult, yet is the key and difficult part of the public and private law's convergence project." The incessant reliance on Article 52 (5) in the application of administrative law (mandatory) norms in civil law is in stark contrast with the direct application of civil law in administrative law. [13] Whether these administrative norms should invalidate the contract will be elaborated in the following.

III. Legal Analysis of Typical Difficult Cases

The Statistical analysis of the invalidation of an illegal contract has been presented earlier in the article. This part mainly

[13] The fundamental reasons of the application of administrative norms and civil norms in each other's fields are the same. That is, from a holistic legal view, the holes left intentionally or unintentionally in the normative order of either administrative or civil law requires the norms in each other's fields to fill.

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deals with the most common and typical cases concerning the invalidation of an illegal contract.

A. Contract Invalidated Due to Unentitled Contractual Act

According to Tables 4 and 7, housing contracts invalidated by its violation of Article 38 of the Urban Real Estate Administration Law of the People's Republic of China have topped the list. Among them, housing contracts that transfer a real estate under joint ownership without the written consent of other owners, which violates Section 4 of Article 38, are very common. Despite regulations stipulated by the Chinese Contract Law and its Judicial Interpretations by Chinese Supreme Court, courts would rather rely on the Chinese Urban Real Estate Administration Law while invoking Article 52(5) of the Chinese Contract Law to deal with the validity of the unentitled contractual act. Therefore, it is necessary to discuss unentitled act under the heading of the invalidation of the illegal contract.[14]

For instance, one court decision in Sample 1 provides, "according to Section 4 Article 38 of the Chinese Urban Real Estate Administration Law…In our case, the defendant sold the property jointly owned by him and his wife without the consent of his wife, which violates the mandatory provisions of Article 38 Clause 4. According to Article 52(5) of the Contract Law, a contract that violates the compulsory provisions of laws and administrative regulations shall be null and void."

We believe that this courts' approach to the validity of the unentitled contractual act is questionable for the following reasons. First, according to the ordinary meaning, the phrase "shall not" has two meanings in Chinese. One refers to the lack of competence to perform an act. The other refers to the prohibition of an act. An act is invalid only when this phrase has the meaning of the latter. The phrase "shall not" in Article 38 Clause 4 of the Chinese Urban Real Estate Administration Law means the lack of

[14] In fact, disposition without right and invalidation of illegal contract are two different issues. The latter one is prerequisite and determinative. If the contract is illegal, there is no need to discuss the validity of contracts to which the seller has no right to dispose; only when the contract is not invalidated because of its illegal nature, a further step can be taken to discuss the validity of contracts to which the seller has no right to dispose from the perspective of legislation theory and interpretative theory.

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competence and this lack of competence can be remedied by the ex post consent of other parties. In addition, such an unentitled contractual act neither jeopardizes public order. A contract is invalidated only when an unentitled contractual act harms public interest rather than private interest. As Professor SU Yongqin put it, "The legal principle that governs unentitled contractual act can be applied to govern the validity of a contract. The most unentitled contractual act can be remedied by the ex post consent of people who are entitled. The same applies to most invalid contracts. Both the Mainland and Taiwan often ignores this."[15] This remark is indeed insightful.

Second, Article 191 Clause 2 of the Chinese Property Law also exemplifies this point. According to this provision, a mortgagor shall not transfer the property under mortgage during the mortgage term without the mortgagee's consent, unless the transferee pays off the debts on its behalf so as to eliminate the right to a mortgage. Here, the phrase "shall not" is commonly understood as the lack of competence. Since the unentitled contractual act by a mortgager doesn't harm the public interest, such an act should not be deemed invalid. Given this provision resembles Article 38 Clause 4 of the Chinese Urban Real Estate Administration Law to a great extent, the latter should be understood in the same way.

Third, the transfer of a real estate under joint ownership by one owner without the consent of other owners is a typical unentitled contractual act and thus should be governed by the basic principles that govern unentitled contractual act. As some scholars put it, "the transfer of a real estate under joint ownership by one owner should be deemed as an unentitled contractual act and thus should be governed by Article 3 of the Judicial Interpretation on Issues Concerning Sales Contracts issued by the Chinese Supreme Court. Accordingly, the contract is valid, although the validity of the title transfer depends."

Fourth, under the Chinese property law, the title transfer of a real property shall become valid after it is registered according to law. Since it is impossible to register the title transfer without the consent of other owners, the title transfer will not be effective. Thus, it is not necessary to invalidate the unentitled contractual

[15] See Su Yongqing: the correct and erroneous application of Art 52.5 of Contract Law—discussion of referral term based on civil code, published on The Legal Blog, http://longweqiu.fyfz.cn/art/491189.htm, visited on 2013.7.28

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act to protect the other owners. According to the "normative purpose theory" in Germany's legal practice, an unentitled contractual act should not be invalidated unless it goes against the purpose of the principles that govern it.[16]

B. Is "Uncertificated Real Estate" Contract Invalid?

Article 38 Clause 6 of the PRC Urban Real Estate Administration Law provides that real estates that have not been registered and obtained ownership certificates in accordance with the law shall not be transferred. Many court decisions invalidated contracts in violation of this provision. For example, one court decision provides that "The defendant signed a housing contract with the plaintiff, although he didn't obtain the ownership certificate. This contract is invalid because it violates the mandatory provisions of Chinese law."

However, some judge pointed out in 2003 that Clause 4, 5, and 6 of Article 38 of the Chinese Urban Real Estate Administration Law are all administrative regulations. There are similar opinions in the Chinese Supreme Court. For instance, Judge Liu Dequan holds the view that "Article 38 Clause 6 of the Chinese Urban Real Estate Administration Law is a mandatory provision on administration rather than a mandatory provision on validity. The violation of this provision doesn't necessarily lead to the invalidation of the contract."

This conflict in court decisions illustrates the chaos concerning the validity of uncertificated real estate contracts. Some scholars argued, "The provisions governing uncertificated real estate contracts are in fact an authorization of power to particular administrative organs. The purpose is to achieve the social management functions of such organs and to maintain administrative order. Thus, these provisions are administrative regulations." This article agrees with this view. To acknowledge the validity of uncertificated real estate contracts doesn't really affect the public interest. Neither does the mutual agreement between contractual parties. Therefore, according to the principle of invalidating the

[16] Art 6 of "The Meeting Minutes on Issues Concerning Difficult Problems in the Housing Contract Cases" of The People's High Court of Beijing stipulated that where one party of the spouse sells a jointly-owned house without the other party's consent. This kind of sell contract to which the seller doesn't have right to dispose is still valid.

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contract with restraint, there is really no point finding such contracts invalid.

In addition, a real estate can be uncertificated for various reasons. It might be because the real property is an illegal construction. It might also be that the construction is legal but it just hasn't received the title certificate. The latter is common in real estate transactions. Thus, it is improper to treat different types of uncertificated real estate contracts alike and find them all invalid. As Professor CUI Jianyuan put it, "uncertificated real estate contracts should be treated the same as sales contracts of future delivery residential apartments or of future objects. Both involve selling one's own property and both are valid. The better approach is to apply Chinese contract law and its Judicial Interpretation rather than the Chinese Urban Real Estate Administration Law because the former is the new rules. Accordingly, uncertificated real estate contracts should be found valid."

Moreover, according to the factor analysis proposed by Professor SU Yongqin, regulations that stipulate governmental approval as the precondition for obtaining a certificate are all procedural regulations and should be enforced in a flexible way. As he put it, "the flexible enforcement of procedural regulations is the trend in both the Mainland and Taiwan." [17]

Finally, it is worth noting that uncertificated real estate has nothing to do with the land use right. According to Article 9 of the Judicial Interpretation on the Application of Law concerning Contracts on State-owned Land Use Right issued by the Chinese Supreme Court, contracts on the transfer of land use right concluded before the transferor's obtaining the certificate for the granted land use right are invalid. The law specifically provides this invalidation to maintain economic order. Both the contract on land use right and the examination and approval procedures bear the characteristics of administrative licensing. Unlike land, an uncertificated and legally constructed real estate doesn't belong to the state. Moreover, neither the registration nor the obtaining of title certificate has anything to do with administrative licensing. Thus, the disposition of expectable property right will not endanger economic order.

[17] See Su Yongqing: the correct and wrong application of Art 52.5 of Contract Law—discussion of referral term based on civil code, published on The Legal Blog, http://longweqiu.fyfz.cn/art/491189.htm, visited on 2013.7.28

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C. Policy Factors Concerning the Determination of the Validity of Contracts

According to Table 7, contracts invalidated by the violation of the Chinese Land Administration Law have topped the list. Among them, the violation of Article 43 (regarding the prohibition of the use of collective land for construction) is the most common. But in fact, those invalidated contracts were about urban dwellers purchasing homestead and housing. Thus, the invoking of Article 43 is not accurate. Laws governing land use in China are greatly influenced by political factors, same with the validity of contract concerning land use.

Until recently, the legal basis for the prohibition of urban dwellers purchasing homestead and housing mainly includes a 1999 notice issued by the Department of the State Council and a 2004 decision issued by the State Council. But neither qualifies as administrative regulations. Thus, neither constitutes a mandatory provisions. However, in practice, it is the 1999 notice and 2004 decision that invalidate sales contract of homestead and housing.

Although this complies with China's public policy, the application of law is still debatable. In response, the Chinese Supreme Court pointed out that the transfer of homestead and housing in violation of law or public policy or other acts that deprive peasants of their land use right shall be invalidated. This explicitly shows that the transfer of homestead and housing in violation of "public policy" is invalid. It also explicitly manifests the role political factors play in determining the validity of such transfer.

However, there are cases in which courts found the transfer of homestead and housing in violation of public policy valid. For example, one court decision held that, "although the land qualifies as rural collective land until now, this court still affirmed and found the transfer valid in order to respect the status quo, and to maintain the order of market transactions." This reasoning is far from persuasive.

First, the full performance of a contract is not a legal justification for an invalid contract to become valid. Even applying this logic, the land remained rural collective land and the pur-

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chaser also remained urban dwellers before this court decision.[18] This means that the contract has not been fully performed before the court decision. Thus, this reasoning doesn't stand. Second, the respect for status quo, the maintenance of the order of market transactions, and the principle of good faith are all abstract and uncertain. They neither qualify as legal basis nor do they have an objective standard. In fact, many transfers of homestead and housing are found to be invalid despite full performance long ago.

Many Chinese scholars think the correlation between sales contracts of homestead and housing and public interest such as the protection of arable land is too farfetched and thus such correlation doesn't justify the invalidation of these contracts. This article holds the view that such contracts should be deemed invalid from a practical perspective because it is explicitly stipulated in the Judicial Interpretation issued by the Chinese Supreme Court that sales contracts of homestead and housing in violation of public policy should be invalidated. However, from a theoretical perspective, since "public policy" is closely related to "public interest", sales contracts of homestead and housing in violation of public interest should also be invalidated. Here, the public interest is not limited to the protection of arable land. It also includes the prohibition of overconcentration of land, the protection of rural collective economic system, and so on.

D. Professional Public Orders in the Determination of the Validity of Contract

As Table 7 shows, most mandatory provisions on validity stipulated in the Chinese Administrative Law concern practicing or business qualifications of parties to a contract. Table 6 further demonstrates that contracts invalidated by qualifications not in compliance with the law have topped the list (235 cases in total). Thus, it is necessary to examine whether a regulation on qualification qualifies as a mandatory provision on the validity or a mandatory provision on administration. The following part is the

[18] In fact, in determining whether the contract is invalidated due to the violation of mandatory provisions, there is also an issue about timing. That is, whether to use time when the contract is made or when the judgment is made as the baseline time. Precedents from France still used the former as the baseline time. V. Cass. civ. 1re, 10 févr. 1998, JCP. II.10142 note B. Fages, D. 2000.442, note L. Gannagé, RTD civ. 1998.669, obs. Mestre. German law also takes the same ground.

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analysis of Article 11 of the Chinese Non-State Education Promotion Law.

One court decision held that "the Yuanhang School no longer has the qualification required to temporarily provide education since May 12, 2005. Thus, the educational cooperation contract between three parties concluded in the February of 2006 should be invalidated." Another court decision, on the contrary, held that "although the Training and Employment Agreement is invalid, the provision that provides justification for its invalidity is not a mandatory provision on validity." Both court decisions rely on the same provision, Article 11 of the Chinese Non-State Education Promotion Law. Both decisions were by the same court. It is astonishing that the same court treated this same provision differently in different decisions.

According to some scholars, if a party that lacks the qualification required by law illegally enters the market, it is this party that should be punished not the market. This means that the party should bear the responsibility for his violation of administrative law or even criminal law, but the juristic act should still be valid. Similarly, other scholars point it out that the lack of required qualification usually doesn't affect the validity of a contract. Likewise, others scholars hold the view that legal requirements on safety examination and approval, allocation of resources, approval, and qualification, in theory, don't constitute mandatory provisions on validity.

We believe that the Chinese Supreme Court's interpretation is way too rigid while the scholarly opinions are too flexible. The examination of the nature of a legal provision should start from the provision itself. If a provision aims to protect the public interest or the interest of the public (including but not limited to parties to a contract), such as the provision concerning the production qualification for special safety equipment and the qualification for medical practice, it qualifies as a mandatory provision on validity. According to professor Su Yongqin's factor analysis, if the purpose of a provision is protection, the failure to comply with the qualification required by such a provision will lead to the invalidation of a contract.[19] On the contrary, if such a provision

[19] See Su Yongqing: the correct and wrong application of Art 52.5 of Contract Law—discussion of referral term based on civil code, published on The Legal Blog, http://longweqiu.fyfz.cn/art/491189.htm, visited on 2013.7.28

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doesn't aim at protection but regulation, the failure to comply with qualification required by such a provision, such as qualification concerning mining, will not lead to the invalidation of a contract.

Administrative regulations on qualifications might become mandatory provisions[20] because they often encompass the so-called "professional public order",[21] which is one kind of political public order.[22] This is the real reason for the invalidation of contracts not in compliance with such regulations.[23]

Admittedly, even in France, not all rules on professional ethics that specify responsibilities of practitioners constitute the public order. It is only when they aim to protect the interest of parties to a contract that they constitute the public order. Only when they constitute the public order, will the violation of such rules lead to the absolute invalidation of contracts.[24] The German law makes a distinction between professional order and professional guideline. The professional order established by industry associations with lawmaking power (such as the professional order for doctors, lawyers, and engineering surveyors) qualifies as mandatory provisions. But professional guidelines established by such industry associations are different. The violation of such professional guidelines only constitutes the violation of boni mores.

It is not always easy to identify the professional order. French courts once had conflicting decisions regarding contracts concluded by financial institutions that were deprived of business

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[20] Article 12 of the Chinese Administrative License Law lists five categories of licenses: major activities approval, access of resources, occupational requirements, safety product review, the establishment of legal subject.

[21] Professional public order means the practicing rules that are made to protect the general welfare and to prevent the public from being harmed by the incompetent or unethical professionals. V. F. Terré, P. Simler, Y. Lequette, Les obligations, 10e éd., Dalloz, 2009, no 381, p. 395.

[22] Professor Malaurie, however, defines professional public order as one kind of economic public order. See P. Malaurie, L. Aynès, P. Stoffel-Munck, Les obligations, 4e éd., Defrénois, 2009, no 650, p. 325.

[23] Article 11 of Administrative License Law establishes the principles of setting administrative license, the core of which is to "protect the public welfare and social orders." Therefore, the following 5 specific categories listed in Article 12 [of the Administrative License Law], by logic, entails general welfare and social orders. Of course, this is not necessarily true.

[24] V. Cass. civ. 1re, 5 nov.1991, Bull. civ. I, no 297 p. 195, CCC 1992 no 24, note L. Leveneur, RTD civ. 1992, 383, obs. J Mestre.

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permit and lost their qualifications. However, in a case decided in 2005, the Supreme Court Justices unanimously agreed that these contracts were valid. [25] Similar things happened in Germany. When interpreting a regulation on qualifications, it is necessary to consider which interpretation better protects parties to contracts. For example, a credit contract concluded by a bank that lacks business qualification is commonly understood as a valid contract, although the bank's lack of qualification violates the law.

We believe that if a provision aims to protect the essential interest of the public, it should be deemed as a mandatory provision on validity. It is because in such a provision, the aim to protect the public interest and the public order is clearly manifested. For example, one provision invalidates the construction contract concluded by a constructor who lacks the legally required capacity to construct. This is because such a provision not only aims to protect parties to the contract but also aims to protect the public, such as the residents. However, the Chinese law should aim at narrowing the scope and specifying the standard of professional public order.

E. Supplementary Types: The Misunderstanding of the Validity of Contract concerning Economic Crimes

The sample of this article concerns the invalidation of illegal contracts. However, there is a different situation when the validity of a contract is more drastically denied. Article 11 of the Judicial Interpretation on the Trial of Economic Crimes issued by the Chinese Supreme Court provides that if a seemingly economic dispute turns out to be related to economic crimes during the trial, courts should dismiss the case and transfer the materials to the police or the procuratorial authorities. This provision drastically denied the validity of a contract related to economic crimes.

For example, one court decision provides "during the trial, the case involving fraud is under investigation by the police. Thus, it is proper to dismiss the case according to Article 11 of the "Judicial Interpretation on the Trial of Economic Crimes."

The aforementioned court decision is not the only one of this kind. Despite differences in facts, these cases reveal one

[25] Cass. Ass. Plen., 4 mars 2005, RDC 2005. 1046, obs M.-A Frison-Roche, RTD civ. 2003.388, obs., J.Mestre et B.Fages.

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thing in common: the involvement of economic crimes will lead to the dismissal of a case. Obviously, this means that the contract is invalidated without trial under civil law. Once a contract constitutes an economic crime, there will be no possibility of examining the validity of this contract. This approach is named "the supremacy of criminal law over civil law."

However, this approach distorts the relationship between civil law and criminal law. Generally speaking, civil law and criminal law are independent, although they have an impact each other. This influence is mainly manifested in the sequence of the trial. Criminal law violations should be tried before civil law violations. In this way, the result of a criminal trial can influence the result of the subsequent civil trial.[26] This is also true in the French law.

To try criminal law violations first can improve efficiency, save judicial resources, and avoid the negative impact exerted by the comparatively lower standard of proof in civil trials. However, this rule is not absolute. According to Article 150 of the Chinese Civil Procedure Law, only when the result of a civil trial hinges on that of another unfinished criminal trial, should courts try criminal law violations first. However, in many cases, to try a criminal law violation first is not necessary and might even harm the contractual parties' interest. This is because it might take a long time before a criminal law case can be concluded. Thus, scholars often drastically criticize the approach of "the supremacy of criminal law over civil law."

In addition, using criminal law to abolish civil law can never be correct. Scholars understand Article 11 as the abolition of civil law by the involvement of criminal law violations. This approach exceeds the approach of "the supremacy of criminal law over civil law." This is called "the use of criminal law to abolish civil law." There are fundamental differences between civil law responsibilities and criminal law responsibilities in terms of purposes, means, factors, and legal consequences. Thus, using criminal law to abolish civil law is against the basic principles of law. Whether a crime can be established and whether a contract is valid should be tried separately. The factual determination of

[26] Article 9 of "Some Provisions of the Supreme People's Court on Evidence in Civil Procedures" stipulated that parties bear no burden of proof to prove adjudication that has already taken legal effects by the people's court.

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criminal cases can influence the result of civil cases. But the results of criminal cases cannot dominantly affect those of civil cases.

In fact, this principle can be extended to crimes beyond fraud. Court decisions that invalidate a contract without taking into account the facts of a case are against the basic principles of law. Judge Xu Ruibai from the Chinese Supreme Court holds the view that Article 11 of the Judicial Interpretation on the Trial of Economic Crimes is contradictory to Article 1.[27] Moreover, he thinks that when a case involves both civil law violations and criminal law violations, courts should transfer only those materials and evidence related to criminal law violations to the police or the procuratorial authorities.[28]

However, Article 7 of the Illegal Fundraising Opinions issued by the Supreme Court, the Supreme People's Procuratorate, and the Ministry of Public Security provides that "for an illegal fund-raising criminal case that is subject to the investigation, prosecution or trial, if the case is filed based on the same facts, courts shall not accept the lawsuit and should transfer the relevant materials to the public security organ or the procuratorial organ." This provision is incorrect. Contracting parties' violation of criminal law doesn't necessarily mean the object, purpose, procedures, or the qualifications of contracting parties of a contract is illegal. One party's criminal motivation doesn't lead to the conclusion that the purpose of a contract violates the criminal law. Only when the criminal motivation of one party is known and accepted by the other party, can courts conclude that the purpose of a contract violates mandatory provisions.

Ironically, one of the bulletin cases issued by the Chinese Supreme Court points out "when private lending constitutes illegal fundraising, contracting parties might be held criminally responsible. However, this doesn't affect the validity of this

[27] Article 10 of the Fashi (1998) No.7 stipulates that "In trying economic dispute cases, the People's Court should transfer all clues and materials that are related to the present case but involves different legal relationship to the relevant police or procuratorate authorities. The economic dispute will continue to be tried.

[28] Xu Ruibai, The Judicial Solution to the overlap between civil and commercial dispute and criminal dispute, published on Chinese Criminal Law, website: http://www.criminallaw.com.cn/article/default.asp?id=2177, visited on 2012.07.25

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contract and its security contract."[29] This is in conflict with the Illegal Fundraising Opinions, which manifests the undetermined positions of the Chinese Supreme Court.

IV. SOLUTIONS AND SUGGESTIONS

In the second part of this article, we have discussed the most common and typical mistakes made in adjudications about invalidation of contracts. If the mistakes are corrected, it will be easier to identify mandatory provisions on validity. So, the first step to be taken is to improve the reasoning of the judgment. Art 52.1.5 of Contract Law is a referral term[30], the application of which needs to refer another special law. Among the gathered samples, we haven't found the referred norms in a large part of the adjudications. The lack of referral might be related to the difficulty of identifying mandatory provisions on validity. Strictly speaking, the lack of referral is a mistake in the application of law, and it should be corrected.

Specifically, this problem can be solved in the following ways. First, in the housing contract cases where the house is sold by a spouse unentitled to dispose, and the sold house is uncertificated, the rules of unentitled disposition and the dichotomy of property and creditor right shall be observed. According to these rules, under these two situations, the contracts are valid. This conclusion is made from the perspective of interpretators.

Second, the coverage of the administrative licensing should be cut down.[31] Legislators, where the market can function well by itself, can reduce the mandatory provisions requiring administrative license so as to easing judges' difficulty in identifying [the violation]. This is the position of the legislative theory. For the interpretative theory, there are several points requires attention.

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[29] See Gazette of the Supreme People's Court, 2011 volume 11, Wu Guojun v. Chen Xiaofu, Wang Kexiang, and Zhongjian Real Estate Developing Company of Deqing County.

[30] Referral term is the channel through which the policy concerns of regulatory norms be brought into legal relationship between private parties. The concept of "general term" focuses more on judge's identification and evaluation of the regulatory norms. Supra fn20, Su Yongqing.

[31] Professor Geng Lin even suggests that the violations about qualification and capacity could can be regarded as one category which doesn't touch on the validity of the contract. See Geng Lin, Mandatory Provisions and the Validity of the Contract, Peking: Democracy and Legality Press, 2009, p298.

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To start with, for the administrative licensing norm on legal qualification, the interpreter should ascertain for the main purpose of the norm, whether it is to protect the random individuals, or it is to protect the private interests of the other side of the contracts. If the latter one is the main purpose, the norms can be interpreted as the mandatory provision on validity only when the lack of the license might seriously harm the other side of the contract either personally or financially, like the norms about medical practitioner's qualification. Other norms about licensing for operation in common fields. For example, the license for advertising, should not be interpreted as mandatory provisions on validity.

Besides, the interpreter should also consider whether the invalidation of the contract is better for protecting the other side of the contract. If not, there is no need to invalidate the contract. Art 12 of Fashi (2004) No. 14 states that "Where a contract on undertaking a construction project is invalid, but the construction project is inspected at the time of completion to be qualified, the contractor's request for payment of the construction cost by considering the contractual stipulations for reference shall be sustained." This approach mitigates the invalidation by supporting unpaid contractor's claim, which shows that invalidation is not necessary when the other side of the contract is fully protected. This is the reflection of the proportionality principle. This principle, though deriving from administrative law, can be extended to the field of private law and to the crossing field of private law and public law. The principle of proportionality is a necessary methodology in balancing the purpose of norms and the private autonomy.

Third, legislators should reduce the range of the mandatory economic public order. This is the direction the legislative theory is headed. France, where state-owned economy occupies large part, can be taken as an example. In France, the main substance of mandatory economic order is currency and price regulation. After the issuance of the orders about the autonomy of pricing and competition in 1986, the government doesn't control the pricing anymore except for special regulations. The planned economy which is guided by the socialism gradually gives way to the market economy guided by neo-liberalism. Up to now, in France, the mandatory economic order mainly exists in competition law,

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and is becoming increasingly important. Compared with France, mandatory economic order still exists in a lot of fields in China. For example, loans made between corporations are banned. The mandatory economic order is intended to protect the economic, financial, fiscal, taxation, pricing and other basic institutions. As mentioned above, most of the gathered cases are about violation of the norms in these fields. The market economy has been implemented in China for years, but China's market economy status hasn't been recognized by many western countries. One reason is the [government's] excessive control over the economy. Therefore, it should be our future direction to loosen control to some extent and show more respect to the private autonomy. That is the so called as "the deduction of the negative factors in the national conditions."

Fourth, for the contracts which violate the norms aimed at protecting the weak side[32], the legislator should set them as revocable instead of invalid contract. This kind of norms normally has the formal requirements for notifications[33], and the rules on clauses abusive[34]. In China, a typical case is the so-called excessive profits. This primary purpose of this kind of norm is to protect the other contracting party instead of the public interests. Therefore, regarding it as semi-mandatory provisions or norms granting a unilateral right would be enough to protect the weak side. This is especially true when the norm is a procedural requirement instead of a substantive requirement.

Finally, we shall keep a bright line between civil law and criminal law, and prevent the abusive use of the article 11 of Fashi (1994) No.7 and the Opinions on illegal capital raising in order to avoid the extension of criminal law into civil law. In years, the Chinese Supreme Court has made some efforts to

[32] This unequal circumstance often happens between the employer and employee, insurer and insured, leaser and tenant, producer, seller and buyer. V. P. Malaurie, L. Aynès, P. Stoffel-Munck, *Les obligations*, 4e éd., Defrénois, 2009, no 650, p. 326.

[33] The Supreme Court of France points out that the notification requirement of mortgage in Consumer Code (Code de la consummation is intended to protect debtor, and only the debtor can bring a claim to invalidate the contract. V. Cass. civ. 3e , 7 nov. 2007, no 06-11.750, *Bull. civ*. III, no 199.

[34] Precedents from France hold that the public order in L.312-16 of Consumer Code (Code de la consummation) prohibits the agreement that violates the provision's requirement and adds contractual obligation on the buyer's side. V. Cass. civ. 3e , 7 nov. 2007, no 06-11.867, *Bull. civ*. III, no 201.

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correct the past mistakes, for example, in *Chongqing Huayan Credit Cooperative v. Chongqing Dapeng Corporation*, the criminal cases' victim made a claim for liquidated compensation based on a valid contract, and the Chinese Supreme Court sustained such claim. Meanwhile, the High Courts in some provinces have issued normative documents to deal with the issue, for example, there is an "Opinion of the Higher People's Court of Shanghai Municipality on Handling Several Issues about Criminal Procedural Issues Involved in Civil Disputes." Nonetheless, the abusive use of the two normative documents is a nationwide phenomenon. There are countless adjudications which harm the contract parties' substantive rights and procedural rights. We suggest that the two normative documents should be abolished. In addition, it shall be clarified that in the crossing field of criminal law and civil law, whether we should invalidate a contract shall be determined based on the basic rules and principles of civil law. The judges should specify in their judgments which element of the contract violates the mandatory provisions on validity, instead of invalidating the contract based on an abstract reason that the contract parties are involved in criminal activities.

V. Conclusion

The validity of illegal contract or the identification of mandatory provision on validity is an issue which hasn't receive much consensus both in theory and in practice. This article aims at finding out the most typical mistakes by analyzing the gathered cases, and then to put forward suggestions. These are the necessary steps to achieve the final resolution of the problem. The empirical study shows that the most common contracts in the discussion about invalidation of illegal contracts are housing contracts, land usage transfer contracts, construction contracts, leases, rural land contracts, and loan contracts. Usually, these contracts are illegal because of the contractual parties' lack of capacity or because the object of the contract is illegal. The following regulations are most commonly violated: the regulation about owners' qualification and the use of the land in "Land Administration Law", the regulation about the contractors' qualification in "Interpretation of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases of Dispute over Contracts on Undertaking Construction Projects",

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the regulation about banning loans between corporations in "General Rules of Loans", the regulation about restrictions on selling houses without certificate or without the co-owner's permit in "Urban Real Estate Administration Law", the regulation about invalid contract concerning illegal construction in "Interpretation of the Supreme People's Court on Several Issues concerning the Application of Law in the Trial of Cases about Disputes Over Lease Contracts on Urban Buildings."

In practice, the confusion [of invalidating illegal contract] mainly lies in the following aspects: (1) to which one party doesn't have right to dispose the house; (2) of transfer of house without certificate; (3) of urban residents' purchasing rural homestead, (3) to which one party lacks capacity; (4) to which one party violates criminal law. Usually, there are the following mistakes: (1) the identification of mandatory provisions on validity, (2) inconsistent standards in adjudications, (3) the excessively broad range of mandatory provisions on validity, (4) extension of criminal law into civil law. We suggest that (1) the application of norms should be corrected; (2) the standards in adjudications should be consistent; (3) governmental control should be loosened; (4) the criminal trial's intervention into the civil trial should be prevented.

In general, because the legislator cannot regulate everything, so the best legislation choice is to use categorization as basis, with interest balance as the supplementary adjustment. The balance of interests is needed because categorization lags behind the time, and categorization cannot cover everything. The balance of interest requires professional expertise and ethics. According to "Guiding Opinions of the Supreme People's Court on Several Issues concerning the Trial of Cases of Disputes over Civil and Commercial Contracts under the Current Situation", the following factors shall be attached importance to: (1) purpose of the norm, (2) the balance of conflicting interests, (3) protection of transaction security, (4) the object of regulation. Professor Su Yongqin has raised several factors for consideration, including the advantage, the orientation, the field, and the cost-interest rate of the regulation. Given to these normative documents and theories, the way to identify mandatory provisions on validity becomes clearer. Under this situation, it seems necessary to conduct research on the practices of invalidation of illegal contracts. It is

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true that an ideal model cannot be detached from reality, but "the sociological methods can find out the actual demand of the society, and provides backup for evolution." American sociologist Earl Babble has said that logic and observation are the two cores of science and are closely related to the three aspects of scientific research (theory, data collection, data analysis). He has also stated that data collection and analysis are essential steps toward the resolution. This statement is enlightening to this issue. Only when there is a theoretical logic as well as specific judicial practices, can the system of invalidation of illegal contracts be bettered over time. This article focused on the latter one. There are still rooms for discussion in the former part, which is the construction of the theoretical framework in identifying mandatory provisions on validity. Subject to the length of this article, such discussion can be left to future articles.

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Restitution of Benefits Acquired through Illegal Contract：Regulation of Bad Faith Behaviors

XU Defeng[*]

ABSTRACT

In the absence of the rule of non-recovery under illegal enrichment, if a contract is deemed as invalid, only restitution and damage are provided in Chinese Contract Law Article 58. Such outcome is not only unreasonable under legal dogmatics but also cause the side effect of helping or even encouraging bad faith behavior. Breach of trust is a violation of the principle of abiding by the agreements, which has been a fundamental social principle. The Indulgence of "breach of trust" would ruin the fundamental principle of good faith, which is highly relied by market and even the whole country. With the increasing numbers of regulations, tension has been gradually cumulating between the regulation and the good faith: the parties of private law can take advantage of regulation to "legally" get rid of the contract in bad faith, which is more remarkable considering Chinese rule of restitution under the illegal contract. In order to balance the implementation of regulations and good paper, this paper argues that the better way is to take into consideration the factors including purpose of law, the degree of severity of illegality, parties' subjective state and the content of enrichment. In addition to deal with the recovery under illegal contract, the aforementioned idea of promoting good faith and hindering bad faith also has a general usage in the interpretation and application of other civil and commercial laws.

Key words: *Contract Law, Invalidation of Illegal Contract, Illegal Enrichment, Breach of Trust*

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[*] XU Defeng, Professor, Peking University Law School. The author would like to thank to the help of Haoyang Zhang, Minna Huang. This article is the staged result of National Top Young Talented Supportive Program "Legal Dogmatics and Value Judgment." This translation was produced by LI Shujun, WU Huizi, HE Jiahuan and WANG Yue from Peking University School of Transnational Law.

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I. QUESTION PRESENTED

Once a contract has been invalidated, there are three main outcomes provided in Article 58 and 59 of Chinese Contract Law and Article 61 of General Principles of Civil Law: restitution, damage, property confiscation to the collective group or the third party. Since the third outcome concerns about the third party protection outside the contract, mainly in the area of administrative law or criminal law and only happens when designated agencies, collective group or third party fail to do so. It would be hard or impossible to design such a procedure for judiciary branch to reclaim such property, so it won't be discussed in this article. This article will focus on the restitution and damage parts which are frequently used in civil and commercial laws. The following research shows, those two ways of regulations' legal character, constructive factors, and the relationship are needed to be figured out. From the point of legal effect, restitution (based on the value at the point of contract signing) not necessarily has the effect of preventing illegal conduct, on the contrary, in some situation, it also helps parties get unjust enrichment through invalidating the contract in bad faith. Such as in some cases[1], seller regains the ownership of homestead through invalidating the contract. In other cases,[2] trustee would gain huge investment interest since the contract was invalidated.

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[1] Most of the homestead issues (and the house attached to it) in countryside is under this model. *See* 王笠泽(WANG LIZE), 宋庄房讼纪实 [RECORD OF LAWSUITS IN SONGZHUANG], at 56 (2013).

[2] Set Chinachem as an example, September 1995, Chinachem Financial Services Limited ("Chinachem") signed the Power of Attorney to "entrust China Small and Medium Enterprise Investment Co. Ltd. ("China SME"), director of China Minsheng Bank, to act as its proxy to buy and hold shares in China Minsheng Banking Corp. Ltd., also enjoy the whole benefit of 900 million dollars investment; Tustee will transfer all relevant document in China Minsheng Bank to trustor, China Minsheng Bank will notify the trustor amount and percentage in a timely manner. Trustee cannot sell or mortgage relavant interest without the consent of trustor." Same year July 25, two parties signed a loan agreement: the lender Chinachem agree to loan China SME 909 million dollars. The loan is the capital used to buy China Minsheng Bank shares, which should be mortgaged to lender. Debtor promise won't remortgage or sell them third party without the consent of lender. After that, Chinachem wanted to exercise its shareholder rights, China SME refuse to carry out the obligation listed in Power of Attorney, claiming that China SME is the shareholder of China Minsheng Bank, according to the current law and regulations, Chinachem has no right against it. The Supreme People's Court ruled that the relationship between two party is trust, but also ruled that the contract is against the mandatory rules in mainland China. So

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The current legal framework is not the only reason for the unfair results caused by the invalidation of contract. In fact, scholars have had deep discussion on the invalidation rule. From one hand, the rule of invalidation of illegal contract is necessary, on the other hand, excessive usage of mandatory provisions would limit party autonomy and distort the market rules, and thus pointed out the wrong conception that illegal equals to invalidation. Among all the solutions available right now, the ones worth noting are the differentiation of 'mandatory provisions on administration', 'mandatory provisions on effectiveness' and limit the effect of 'mandatory rules' on the validity of contract. At the same time, scholars also notice that when deciding the validity of the contract, people should evaluate the purpose of law and other relevant elements or other available legal rules rather than contract invalidation to preserve the social benefit.[3]

This article goes further than the aforementioned argument, and discusses the outcome of contract invalidation on the basis of differentiating illegality and invalidation. That means "invalidation doesn't unequal to restitution" and other possible exceptions

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the two deeds of entrustment, together with two loan agreements fell in the definition of "conceal illegal aims in a legal form" which prohibited in General Civil Principles and Contract Law, were invalid and unenforceable. Furthermore, the court ruled that China SME was obliged to return P's original investment of US$10.94 million and should pay Chinachem the compensation, which included 40% of the market value of the shares at issue as well as 40% of the dividends that had accrued on the shares at issue. *See* also 沈景花与杨树朴等股东权纠纷上诉案 [ShenJinghua v. YangPushu et.al shareholder rights disputes] (2004)沪一中民五〈商〉终字第15号, (Shanghai No.1 Intermediate People's Ct. Dec. 30, 2004) CLI.C.24355 CHINALAWINFO.

[3] *See* 谢鸿飞 (Xie Hongfei), 论法律行为生效的"适法规范" [*Discuss on the 'Applicable rules' of how juristic act take into effect*], 中国社会科学 [SOCIAL SCIENCE IN CHINA], issue 6, at 125, 136 (2007); 耿林 (GENG LIN), 强制规范与合同效力：以合同法第52条第5项为中心 [MANDATORY RULES AND THE VALIDITY OF CONTRACT: SET CONTRACT LAW ARTICLE 52 CLAUSE 5 AS AN EXAMPLE] (2009); 黄忠 (HUANG ZHONG)：违法合同效力论 [VALIDITY OF ILLEGAL CONTRACT] (2010). Earlier exploration see 解亘 (Xie Heng), 论违反强制性规定契约之效力 [*Discuss on the Validity of Violation of Mandatory Rules*], 中外法学 [PEKING UNIVERSITY LAW JOURNAL], issue 1 (2003); 孙鹏 (Sun Peng), 论违反强制性规定行为之效力 [*Legal Effect on Juristic Act which Violate Mandatory Rules*], 法商研究 [STUDIES IN LAW AND BUSINESS], issue 5 (2006). Cases adopted this approach including 广东中大中鑫投资策划有限公司与广州市仙源房地产股份有限公司股权转让纠纷再审案 [Guangzhou Xianyuan Real Estate Co. Ltd. v. Guangdong Zhongdazhongxin Investment Planning Co. Ltd., Guangzhou Yuanxing Real Estate Co. Ltd. and China Investment Group Int'l Finance Limited] (2009)民申字第1068号, (Supreme People's Ct. Dec. 20, 2009) CLI.C.290565 CHINALAWINFO.

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exist. The author wants to detail the regulation system, thus increasing levels of regulations on invalidation of illegal contract, decreasing the encouragement of bad faith in the case of invalidation of contract, and finally refining a general rule of regulating breach of trust.

The resolution proposed by this article can work perfectly with the current legal system. For example, in the case of public servant engage in profit-making business, under the current law, simply ruling the transaction is invalid and pay back the investment is unreasonable. Such as Article 53 Clause 14 of Civil Servant Law ("A civil servant shall observe disciplines and shall not have any of the following acts: … Undertaking or participating in any profit-making activity or holding a concurrent post in an enterprise or any other profit-making organization[4]"). If we take the following regulation as mandatory provisions on administrative, the contract would be valid but against the purpose of forbidding public servant from engaging profit making activities. Comparatively speaking, the framework provided by this article can affirm the invalidation of the contract and can protect the interest of relevant parties through restitution.[5]

[4] Current regulation does not forbid civil servant engaging in stock market, see 关于党政机关工作人员个人证券投资行为若干规定 [Provisions on Party Organ and Government Personnel's Personal Investment in Securities] (promulgated by the General Office of the Central Committee of the Communist Party of China, General Office of the St. Council, Apr. 3, 2001, effective Apr. 3, 2001) CLI.5.36208 CHINALAWINFO.

[5] 孙良国 (Sun Liangguo), 再论公务员违反禁止性规定订立营利性合同的效力 [*Discussion on the Validity of Illegal for Profit Business Contract Made by Civil Servant*], 浙江社会科学 [ZHEJIANG SOCIAL SCIENCE], issue 8, at 43 (2011). The author thinks the for-profit business contract should be void, to "cut any possible relation it could be between the profit they got and the position they are". In practice, there are many examples, such as judges violating the Judges Law Article 32 Clause 11. *See also* 俞萍与丁新民合伙合同纠纷案 [Yuping v. Ding Xinmin on partnership contract disputes] (the court finding the partnership contract valid). *See* 黄忠 (Huang Zhong), 比例原则下的无效合同判定之展开 [*Ruling of Invalidation of Contract under Proportionality Principle*], 法制与社会发展 [LAW AND SOCIAL DEVELOPMENT], issue 4, at 55 (2012).

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II. TENSION BETWEEN REGULATION AND GOOD FAITH

As the premise for the discussion below, there is a belief that been tested to be true: respecting and using police power to enforce the contract is crucial in building a low transaction cost, trustworthy and prosper market.[6]

The concept of abiding by the commitment or good faith has the same root as "trust" in the broader area of sociology and political science. "Good faith" is more on the obligor to behave, but "Trust" is more on the obligee, but also includes all the other subjects in the society. There is a common understanding for the important role of trust. To be specific, trust is to be seen as the premise of the market exchange, market prosperity and even the market itself. It is the basis of state governance[7] and also part of the social capital.[8] As one scholar pointed out, "Without the general and universal trust that people have in each other, society itself would disintegrate."[9] From the semantic meaning, trust means "believe and dare to entrust." For its establishment and development depend on the interaction between two parties, hidden shared benefits, shared value and other regulations.[10] Among all these, regulations plays an important role in the formation of trust.[11]

As a crucial element of regulation, law should encourage people to behave in good faith not the other way around. To some

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[6] About the reasonable reliance theory, see 叶金强 (YE JINQIANG), 信赖原理的私法结构 [RELIANCE THEORY IN PRIVATE LAW], at 55-85 (2014).

[7] Confucius once highly stresses the importance of gaining confidence from people in governance. "Tsze-kung asked about government. The Master said, 'The requisites of government are that there be sufficiency of food, sufficiency of military equipment, and the confidence of the people in their ruler.' 'Tsze-kung said, 'If it cannot be helped, and one of these must be dispensed with, which of the three should be foregone first?' 'The military equipment, 'said the Master. Tsze-kung again asked, 'If it cannot be helped, and one of the remaining two must be dispensed with, which of them should be foregone?' The Master answered, 'Part with the food. From of old, death has been the lot of a men; but if the people have no faith in their rulers, there is no standing for the state'"

[8] 郑也夫 (Zheng Yefu), 信任：溯源与定义 [*Trust: source and Definition*], 北京社会科学 [BEJING SOCIAL SCIENCE], issue 4, at 122 (1999); 周怡 (Zhou Yi), 信任模式与市场经济秩序 [*Trust and order of Market Economy*], 社会科学 [SOCIAL SCIENCE], issue 6, at 58 (2012).

[9] THE PHILOSOPHY OF MONEY 177-78 (Georg Simmel & David Frisby eds., 3rd ed. 2004).

[10] 周怡 (Zhou Yi), supra note 8, at 59.

[11] About trust as basis in market transaction and how law building up trust, see 柯林斯 [Collins], 规制合同[REGULATION OF CONTRACT], at 105-138 (Xiaoli Guo trans. 2014).

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extent, private law always treasures "honesty and trustworthiness" as the king provision to govern all private relationships echoes the same point here. Not only the regulation itself, "encourage good faith" and "deter breach of trust" also mean the government need to use all source available to make sure the promise being kept including police power.

However, just as promises between private parties won't be enforced by police power all the time, breach of trust won't be punished all the time either. The deep concern is, modern countries implement tons of regulations to maintain social benefit and promote efficiency. Government on one hand need to be supportive to the private agreement but only deny the validity of certain contract when it's better serve the purpose of the regulation. In civil law, invalidation of illegal contract (i.e. Article 52 Clause 5 of Chinese Contract Law) is the best illustration of this kind of regulatory rules.

Apart from the reasons mentioned above, regulation has special background in Chinese legal history. Since the founding of PRC in 1949, social economy was under complete control, with the implementation of reform and opening-up policy, market transaction start being allowed and regulations begin to loosen up. For this whole process, regulations always been valued higher than other aspects. From the development of law, in the Economic Contract law 1981 version, regulations and relevant invalidation rules are pervasive in it, such as contracts violating the law or state policies and plans, contracts signed by a corporation beyond the scope of its business scope and contracts in violation of price instruction are all void.[12] Under such regulation, it to some extent protect the parties who breach the trust. One party could use contract invalidation as an excuse to breach the contract to cover the real reason that he is not satisfied with the term. The legislators soon realized the drawback of mandatory rules and the respect of private agreement. It shows in Article 50, 127 of Chinese Contract Law (1999) and Article 10 of the Interpretation I of the PRC Supreme People's

[12] *See* 经济合同法 [Economic Contract Law] (promulgated by the Standing Committee of the Nat'l People's Cong., effective Jul. 1, 1982) art. 7, CLI.1.1136 CHINALAWINFO. As to relevant interpretation, see 中华人民共和国经济合同法条文释义 [Interpretation on China Economic Contract law], at 20–24 (1982). Based on the enumeration at that time, "buy and resell", "subtract to others do nothing himself", "fictitious transaction" are all invalidated because of illegal nature. 梁慧星 (Liang Huixing)：经济合同的法律效力 [*Legal effect of Economic Contract*], 法学评论 [LAW REVIEW], issue 3, at 16 (1984).

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Court of Several Issues concerning the Application of the Contract Law and Article 14 of the Interpretation II of the PRC Supreme People's Court of Several Issues concerning the Application of the Contract Law.

In conclusion, even though the degree of regulation is different, government control is still needed. Under this background, regulation and trust are in strained relations. It's hard to make a choice when these two conflicts. Nowadays, plenty of regulations in substantive law have the effect of encouraging bad faith behavior, among which invalidation of illegal contract is a good example.

III. RECOVERY UNDER ILLEGAL CONTRACT SHOULD BE GOVERNED UNDER RULE OF ILLEGAL ENRICHMENT

There is not so much disputes on the restitution rule set by the first sentence of Article 58 under Chinese Contract Law .[13] As for the legal nature of such restitution, main stream of thoughts[14] consider that the 'claim of restitution of property' shall be first resolved to. It can change to 'claim of restitution on unjust enrichment' only when the original property doesn't exist anymore.[15]

The above-mentioned theory is solid but need some improvements. From the nature, "void contract" is not a precise concept. If it is a contract, it should be binding upon both parties, if not, then it is not a "contract". From this point, the concept of "void contract" is a paradox as "void legal act."[16] One thing worth attention is that, different from "void legal act" doesn't affect "legal act" as a codification concept. "Void contract" is an evaluative concept. It means that law does not provide protection either to the signing of contract nor to the performance of contract, that means no protection on any rights listed in the contract. In other words, when a contract being invalidated, the contract itself cannot be a basis for

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[13] 韩世远 (Han Shiyuan), 合同法总论 [General Theory of Contract Law], at 227–29 (3rd ed. 2011); 崔建远 (Cui Jianyuan): 合同法总论（上） [General Theory of Contract Law I], at 357–59 (2008); 朱广新 (Zhu Guangxin), 合同法总则 [General Theory of Contract Law], at 295 (2nd ed. 2012).

[14] 崔建远 (CUI JIANYUAN), supra note 13, at 358.

[15] Some scholars think Art 58 provides separate basis for claim of right, in some special occasions can also refer to rule of unjust enrichments. "For the restitution because of invalidation of contract, Art 58 can serve as a separate basis of claim of right. While Article 58 is not enough, you can refer to unjust enrichment rules and interpretations." 朱广新 (ZHU GUANGXIN), *supra* note 13, at 295.

[16] 朱庆育 (ZHU QINGYU), 民法总论 [GENERAL THEORY OF CIVIL LAW], at 91-100 (2013).

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any claim of right. You have to find legitimate basis outside contract to support your restitution claim.

This article is in the same line of argument most countries have chosen, which is "recovery under illegal contracts"[17] should be governed under rule of illegal enrichment.[18] This choice does not exclude all claim of restitution of property, but putting forward the illegal enrichment rule to decide whether to recover and how to recover. From this point, outcome is irrelevant with whether we adopt the abstract theory of real right.

The reason to use the unjust enrichment to limit rule of restitution is to maintain systematic consistency. That means for the same substantive claim, the result of different application of rules should be the same. For example, M works at counter of the bank and embezzled the money from the bank and later found out by auditor F. To prevent F from reporting, M decide to give F a real estate as a gift and finished registration of real estate. The giving action here is clearly void (even in Countries who adopt abstract theory of real right, the act would also be void because of its illegality). Later the matter was brought into light, M asked F to return the real estate. For this matter, some people argue that even if M cannot claim restitution of unjust enrichment under invalidation of contract, M can still argue right of real claim since the ownership never changed (under Chinese law, we don't adopt abstract theory of real right, when contract is void, the ownership does not transfer). Whether this argument will survive? Among the countries who have the rule of "non-recovery under illegal contract," there is no such disputes about the application of unjust enrichment rule in claim of restitution. Such as in German law, majority of scholars think that should the rule of non-recovery under illegal contract should be expanded and apply not only to claim of rights of unjust enrichment, including claim of restitution.[19] In English law, although case law doesn't think illegal gain would affect change of

[17] CHITTY ON CONTRACTS (VOLUME I, GENERAL PRINCIPLES) §1–177 (Hugh Beale ed., 30th ed. 2008).

[18] Staudinger/Lorenz, 2007, § 817 Rn. 1 ff. BGB; Palandt/Sprau, § 817 Rn. 1 ff. BGB.

[19] Baur/Stürner, Sachenrecht, 18. Aufl., C. H. Beck, § 5 Rn. 52; Flume, Das Rechtsgeschäft, Springer, 1979 § 18, 10; Medicus, Bürgerliches Recht, Carl Heymanns Verlag, 2007, § 27 Rn. 696-698.k, 2009, § 5 Rn. 29, 52. Those scholars don't think the rule of non-recovery under illegal contract should be extended to claim of restitution on ownership. This argument is also important in China, since we don't adopt the abstract theory of real right. For the same reason.

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title,[20] but there is no dispute that the rule of the rule of non-recovery under illegal contracts could apply to claim of restitution.[21] Chinese understanding, which the restitution is actually right of real claim if the original property still exists, is not wrong but to some extent obstruct the study of illegal enrichment theory.[22]

One more thing worth to notice is that, the first sentence of Article 58 under Chinese Contract Law does not differentiate invalidation based on the illegal contract or other reasons, use the same language as contract revocation ("the property acquired as a result of a contract shall be returned after the contract is confirmed to be null and void or has been revoked; where the property can not be returned or the return is unnecessary, it shall be reimbursed at its estimated price), Article 92 of the General Civil Principles listed relevant rules of unjust enrichment but remain silence on illegal enrichment. So, we could conclude that Chinese current law take a different approach which grants recovery even under illegal enrichment." The justification for the simplistic rule of restitution in Chinese Contract Law seems to be that it restores the parties to their original position before performance, thus achieving the effect of deterring illegal transaction and upsetting the parties' illegal purpose. For instance, if the parties transact a legally prohibited object, the effect of restitution can just achieve the regulatory purpose.[23] However, the reality proves to be rather complicated. On

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[20] *See* "As a general rule, title passes at law to the recipient notwithstanding the illegal purpose for which the transfer was made." LORD GOFF, THE LAW OF RESTITUTION § 24–010 (Gareth Jones ed., 17th ed. 2007); Sajan Sigh v. Sadara Ali [1960] A.C. 167, 176–77; Tribe v. Tribe [1995] 4 All E.R. 236, 251; Belvoir Finance Co. Ltd. v. Singleton [1971] 1 Q.B. 210.

[21] *See* SajanSigh .SadaraAli [1960]A.C.167，176~177; Tribe .Tribe [195]4 AlE.R.236，251; Belvoir Finance Co.Ltdm Singleton [1971]1Q.B.210

[22] The first sentence of Chinese Contract Law Article 58 is similar with Article 113 of Civil Code of Taiwan ("When a party made a void juridical act knew or might know that it was void, he shall be liable to recover the status of things to its original condition, or to compensate for any injury arising therefrom. For the latter, some scholar pointed out earlier "it was originally from our country, no other similar legislative precedents" 詹森林 (Zhan Senlin), 民法第113条与其他规定之竞合关系 [*Concurrence relationship between Civil Code Article 113 and other regulations*], 民事法理与判决研究（二） [STUDY ON CIVIL LAW LEGAL PHILOSOPHY AND JUDGMENTS], at 6 (2003); 胡长清 (HU CHANGQING), 中国民法总论 [CHINESE GENERAL THEORY OF CIVIL LAW], at 328–29 (1997); 王伯琦(WANG BOQI), 民法总则[GENERAL PRINCIPLE OF CIVIL LAW], at 202 (1979).

[23] It is particularly worth noting that the "invalidation" based on defective expression of intent differs from the invalidation based on illegal transaction. In the former case, the law renders the relevant transaction void, which is to prevent such transaction from having the effects that parties initially did not pursue.

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one hand, aside from correcting the illegal behavior voluntarily, the parties are more likely to claim the invalidation of illegal contract due to other motives (e.g. to seek greater benefits through invalidating the illegal contract, as mentioned above). One the other hand, to support recovery under illegal contract might encourage such illegal behaviors in certain circumstances.

There is a case[24] in China in which the plaintiff asked the defendant to assist in admitting the plaintiff's daughter into Shanghai Theatre Academy. The plaintiff's wife, Zhang C, provided a letter of commission stating: "I hereby commission Professor Wang A to be responsible for tutoring my daughter, Liu B, in preparation for the entrance examination for colleges of fine arts. Professor Wang A shall invite other professors as needed to cooperate in this matter. …I hereby decide…to pay 200,000 Yuan altogether to Professor Wang A and other tutors related to this matter. In the event that my daughter was not admitted by the time this year's admission ends, I shall pay 50% of the amount stated above to express my gratitude and respect for the efforts expended by professors." Later on, the defendant failed to accomplish the commissioned matter and returned 100,000 Yuan as promised. The plaintiff, however, claimed the invalidation of the contract and requested all related expenses to be returned. The court ruled for the plaintiff, recognizing the promise between the parties was not of tutorial nature, but rather an act that "interferes with the fair competition of college admission". Still, the court exercised its discretion in accordance with each party's degree of fault, holding that the defendant shall return 60,000 Yuan to the plaintiff. Similarly, in another case[25] the plaintiff and the defendant entered into a commission contract which mandated the defendant to apply for an extension of mining permits for the plaintiff. The plaintiff shall

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Thus, such invalidation is not baseless. In the latter case, however, the expression of intent is devoid of defect and parties actively pursue the legal effects of such transaction, while the transaction *per se* is illegal. Under such a circumstance, granting restitution to both parties by law requires extra proof.

[24] 刘A诉王A委托合同纠纷案 [Liu A v. Wang A on Commission Contract Dispute] (2012)闵民一（民）初字第9413号, (Shanghai Minhang District People's Ct. Oct. 26, 2012) CLI.C.1351309, CHINALAWINFO.

[25] 王建伟与刘党生委托合同纠纷案 [Wang Jianwei v. Liu Dangsheng on Commission Contract Dispute] (2014)厦民终字第3544号, (Fujian Xiamen Interim. People's Ct. Dec. 12, 2014) CLI.C.8043360, CHINALAWINFO.

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pay 600,000 Yuan as "facilitation expense" (this should be understood as the commission for bribing public officials or for achieving illegal purpose). The court found: "Application for the extension of mining permits is free of charge. The plaintiff, however, was willing to pay the defendant 'activity expenditure' as high as 600,000 RMB, which clearly exceeds the reasonable range for remuneration and necessary expenses for transportation, food and accommodation. Taking account of the statements made by the parties during police investigation and trial proceedings, it can be concluded that the assent reached by the parties included using illegal means, such as bribery, to obtain governmental permission for extension of mining permit. This promise obviously contravenes statutory prohibitions. Pursuant to Article 54(4) and (5) of Chinese Contract Law, the commission contract in this case shall be recognized as void." This court therefore held that the defendant shall return to the plaintiff 300,000 Yuan which was already paid as "commission or the so called business fee in China." The rulings above upheld the parties' claims for restitution when the contracts were invalidated due to illegality and provided judicial recourse to the party who performed. It is shown from above that under the circumstance where the restitution of unjust enrichment is not prohibited, the State even has to provide assistance to restitution of payment arising out of the parties' illegal behaviors. This is outright unjustifiable. The following analysis shows that in the event of invalidation of illegal contract, whether the parties' claim of restitution shall be supported ought to be decided by the law of unjust enrichment, with a focus on the relationship between "regulation" and "good faith." A clear-cut approach either allowing or disallowing restitution is rather simplistic and thus should be rejected.

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IV. Recovery under illegal contract: Rules and Exceptions

In Civil Law, although the law of unjust enrichment is related to the law of contract to some extent, their constitutive elements and legal effects differ. Compounded with the fact that the mainstream legal theory in China does not acknowledge the abstract theory of the juristic act of real right (the property is returned to the original owner after the contract becomes void), the internal connection between these two branches of laws is easily ignored. In fact, unjust enrichment is closely related to the law of contract, which is bridged by the law of illegal enrichment. The law of unjust enrichment is based on the legitimacy of the contractual act (if the contract is illegal, the performance or the restitution loses its legitimacy), whereas the law of contract is based on party autonomy (the parties enjoy the freedom of contract and bind themselves by their promises). Two systems are intertwined by the law of illegal enrichment. One the one hand, the law, relying on the effectiveness of the contract, has to decide whether to grant binding effect to the agreement freely entered into by the parties. On the other hand, it has to utilize the notion of legitimacy and balances the proportionality between regulatory ends and means when it comes to deciding whether to grant restitution. In this sense, the rule of non-recovery under illegal enrichment is a result of clash and compromise between the law of contract and the law of unjust enrichment. Regulation is the direct cause of the clash, which manifests prominently by the tension between good faith and regulation.

A. Illegal Enrichment: Rule and Exception Intertwined

The basic principle of non-recovery under illegal enrichment is that the law of unjust enrichment protects the status of existing property and its purpose is to eliminate the "unjust" situation in which the enrichment is retained. Performance based on illegal purpose is no longer legitimate, thus depriving the performing party the right to claim restitution by seeking legal protection.[26]

[26] For introduction to the law of unjust enrichment, see 黄忠 (Huang Zhong), 契约自由与国家干预 [*Freedom of Contract and State Intervention*], 华东政法大学学报 [Journal of the East China University of Political Science and Law], issue 5, at 52–65 (2010); 黄忠 (Huang Zhong), 合同自由与公共政策 [*Freedom of Contract and Public Policy*], 环球法律评论 [Global Law Review], issue 2, at 112–23 (2010).

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From the perspective of comparative law, the German Civil Code §817 clearly states that if the purpose of the performance was agreed upon in such a way that the recipient's acceptance of the performance would violate prohibitive provisions or *boni mores*, the recipient of the benefits shall bear the obligation to return (the first sentence). If the performing party is equally liable for the behavior (violating prohibitive provisions or *boni mores*), the party is not entitled to claim restitution, except that the performance is made for entering into an obligation; restitution is still barred for performance rendered in fulfilling the obligation (the second sentence).[27] The scope of this provision is interpreted far beyond its textual meaning, applying to all forms of restitution under unjust enrichment.[28] The Taiwanese Civil Code §180(4) stipulates that the performance cannot be claimed for return if it is rendered for unlawful cause, except that only the recipient is liable for such cause. In English law, a party cannot claim restitution for performance already made if the contract is entered into for illegal purpose.[29] Similarly, American law[30] in principle prohibits the restitution of performance made based on illegal purpose.[31]

Similar to Chinese Contract Law, there also exists tension between regulation and good faith in countries that adopt the rule of non-recovery under illegal contract. For instance, during war time, states usually would enact legislation prohibiting people from trading goods that exceed the upper limits of their prices, out of consideration for preventing soaring prices and market-cornering behaviors. If people violate the rule and engage in such transactions, such illegal contract will not be binding on both parties.

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[27] On the translation of §817, see also 王泽鉴 [WANG ZEJIAN]，不当得利 [UNJUST ENRICHMENT], at 387 (2009).

[28] Vgl. Dauner, Der Kondiktionsausschuß gemäß § 817 Satz 2 BGB, JZ 1980, 495, 499.

[29] See "Whoever is a party to an unlawful contract, if he has once paid the money stipulated to be paid in pursuance thereof, he shall not have the help of a Court to fetch it back again." Collins v. Blantern, 2 Wils. 341, 350, 95 Eng. Rep. 847, 852 (K.B. 1767); Holman v. Johnson, [1775] 1 Cowp. 341, 343; Parkinson v. College of Ambulance Ltd. [1925] 2 K.B. 1; Shaw v. Shaw [1965] W.L.R. 537; Goff et al., The law of Restitution, 17th Edition, Sweet & Maxwell Limited, 2007, § 24–001 ff.

[30] See 5 Williston on Contracts, § 1630 (rev. ed. 1937); B. T. P., Note: Quasi-Contractual Recovery upon Illegal Contracts, 40 Virginia Law Review 1063, 1063 (1954) (Fn. 1); Restatement (Second) of Contract § 197 (1981).

[31] Vgl. Schlechtriem, Restitution und Bereicherungsausgleich in Europa (Band I), Mohr Siebeck, 2000, Kapitel 3.

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However, if both parties perform their own obligation, then neither party is entitled to claim restitution against the other. For another instance, the parties go against the regulation and transact certain regulated products (such as tobacco, drugs, etc.). If the seller claims illegality of the contract and thus refuses to perform the obligation to deliver the goods after the buyer has made the payment, it seems that such claim ought to be supported. There is a German case in which the plaintiff bought an "electronic dog" to avoid speed-limiting measures. Later on, due to the defect in the equipment, the buyer asked the seller to assume liability for product warranty. The Court held that the sales contract was void due to its illegality, and that according to §817(2) both parties were not obligated to return benefits and the seller did not need to assume liability for product warranty.[32] Among the three cases illustrated above, the first one demonstrates that the rule of non-recovery under illegal contract happens to upset the purpose of price regulation and encourages market-cornering behaviors instead, which intensifies the tension (Spannungsverhältnis) between ineffective sanction (Nichtigkeitssanktion) and prohibition on restitution (Kondiktionsverbot). In latter two cases, the rule of non-recovery under illegal contract helps realize the regulatory purpose, but encourages bad-faith behaviors.

In summary, the rule of illegal enrichment involves highly complex balances of values, and thus it presents as many exceptions as rules. German scholars hold the opinion that almost no question in the history of civil law has drawn as much attention from academia and judiciary as §817(2) (non-recovery under illegal contract).[33] The case is similar in English law. In 1999, the Law Commission specifically conducted research on the legal results of illegal contract as part of the Sixth Programme of Law Reform, and issued a lengthy report titled Illegal Transactions: The Effect of Illegality on Contracts and Trusts. Currently, with the precondition of preserving the legitimacy grounds for the rule of non-

[32] Vgl. BGH NJW 2005, 1490; Würdinger, Über Radarwarngeräte und die Zukunft des Europäischen Privatrechts, JuS 2012, 234. In another "electronic dog case"(BGH ZIP 2010, 136), however, the German Supreme Court supported the customer's claims for rescinding the contract and return of goods and payment, given that the invalidation of the contract of sale did not affect the customer's right to exercise rescission. Klöhn, a.a.O., AcP 2010, 804, 814 (Fn. 51).

[33] Vg1. Klohn，a. a. O. ，AcP 2010，804 ，806.

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recovery under illegal contract, countries have made complex exceptions to the rule, in order to prevent one party from gaining additional benefit due to invalidation of the contract, and to better balance the relationship between regulation and good-faith.[34]

B. The Legitimacy Grounds for the Rule of Non-recovery under Illegal Contract

Doctrinal opinions regarding the justification for non-recovery under illegal contract has been centered around the following theories.

1. Civil Penalty (Zivilstrafe). According to this theory, the rule of non-recovery under illegal contract is regarded as a form of "punishment", which makes the performing party bear the negative result of non-recovery.[35] The main criticism against this theory is that it fails to explain why the law only punishes the performing party while both the performing party and the party accepting the performance have violated the law. Second, as a measure that pun-ishes illegal behaviors, the relationship between the conduct and the punishment mainly depends on the number of transaction or the amount of performance, thus often resulting in disproportionate punishment.[36]

2. Non-protection for Illegal Behaviors (Rechtsschutzverweigerung). According to the theory that "nobody should be remedied for his liabilities" (Nemo auditur propriam turpitudinem allegans), those engaging in illegal behaviors should not seek remedy with the help of the state's police power.[37] This theory is historically based and highly persuasive. Similar to the theory of civil punishment mentioned above, this theory still does not explain why only the performing party cannot claim restitution. Besides, liability is not the sufficient condition for rejecting protection to parties who engage in illegal behaviors. In tort law for instance, the tortfeasor's liability could be reduced or even fully discharged if the tort victim is found be at fault. Namely, simply because the

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[34] Vgl. Staudinger/Lorenz, 2007, § 817 Rn. 3 BGB; Palandt/Sprau, § 817 Rn. 18 BGB.

[35] Vgl. RGZ 95, 347,349; RGZ 99, 161, 167; RGZ 105, 270,271; RGZ 161, 52, 58, 60; BGHZ 8, 348, 368, 373; BGHZ 39, 87, 91; BGHZ 63, 365, 369.

[36] Vgl. Klöhn, a.a.O., AcP 2010, 804, 814 (Fn. 52).

[37] See 维尔纳•弗卢梅 (Werner Flume), 法律行为论 [Allgemeiner Teil des Bürgerlichen Rechts], at 461 (1999).

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tortfeasor has "liability" does not mean that he or she is obligated to assume full liability or is totally excluded from the remedial system.[38]

3. Judicial Efficiency and Integrity (Schutz der Justiz). This theory is to some extent related to the idea of "non-protection for illegal behaviors." It assumes that denying such litigation judicial remedy helps the judiciary invest resources on matters in greater need of judicial remedy (e.g. if restitution is granted for the sale of drugs, the court would be obligated to assess the value of the transacted drugs even when the object no longer exists). And it also helps preserve the integrity of the judiciary, preventing parties from requesting the court to support their claim of restitution for statutorily prohibited acts.[39]

4. General Prevention. This theory presupposes that denying parties the claim to restitution achieves the result of deterring the general public from entering into and performing illegal contracts.[40] Legislators for the German Civil Code also particularly stress such function ("support the establishment of *boni mores* and public order") in the records of legislative reasons regarding §817 (Mon. Ⅱ,S.849). In order to justify this theory, one question needs to be resolved: should private law assume the duty of regulation, and if so, to what extent should it assume such duty? This question involves the division of regulatory scope among Criminal law, Administrative law and private law. Regarding this issue, the mainstream theory worthy of acknowledgment opines that Civil Law

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[38] Vgl. Klöhn, a.a.O., AcP 2010, 804, 816.

[39] See an Austrian judgment：OGHZ 4, 57, 60；an example in English law：Holman v Johnson, 98 ER 1120 ("no court will lend its aid to a man who founds his cause of action upon an immoral or illegal act"; an exmaple in Swiss law：BGE 95 II 37, 41; BGE 111 II, 295, 298 („den Geber für seine unsittliche oder rechtswidrige Absicht maßregeln und den Staat der Pflicht entheben, ihm zur Rückgängigmachung der unsauberen Vermögensverschiebung beizustehen"); Klöhn, a.a.O., AcP 2010, 804, 818 (Fn. 74).

[40] Vgl. Canaris, Gesamtunwirksamkeit und Teilgtiltigkeit rechtsgeschaftlicher Regelungen in: FS Steindorff, 1990, S. 519, 523 ff. A Chinese scholar contends that "generally speaking, based on the spirit of private law, such as individual autonomy and freedom of contract, to reinforce the ends of public law with the means of private law is not allowed." 黄忠 (Huang Zhong), 比例原则下的无效合同判定之展开 [*On the Judgment of Nullity of Contract under the Principle of Proportionality*], 法治与社会发展 [LAW AND SOCIAL DEVELOPMENT], issue 4, at 52 (2012). This is an incorrect view.

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has always played the role of providing behavioral norms and regulating illegal conducts.[41] On one hand, sanctions imposed by Administrative Law and Criminal Law are too severe to regulate behaviors that constitute a minor violation of laws or *boni mores*. On the other hand, every branch of law serves the function of regulating behaviors. The basic principles of Civil Law, such as fairness, justice, and good faith, are all guiding norms for the general public.

Currently, the mainstream theory often justifies the rule of non-recovery under illegal contract from the perspective of "judicial efficiency and integrity" and "general prevention".[42] In certain cases (e.g. the claim to restitution is not supported in cases involving grave crimes), the idea of "No protection for illegal behaviors" which is related to "judicial efficiency and integrity" or "voluntary surrender of remedy by the parties"[43] is also reflected (see detailed discussion below).

C. Restitution of Unjust Enrichment under Illegal Contract and Its Limitations

As discussed above, Chinese Contract Law allows restitution when the contract is invalidated due to illegality, whereas in other jurisdictions such restitution is generally prohibited. There seems to be no point in comparing these two different practices. However, a careful look at the comparative law practices reveals that in contrast with the "clear-cut" rule in Chinese Contract Law, there are multiple exceptions to the rule of non-recovery under illegal contract, which are created based on the purpose of regulating bad-faith behaviors.[44] A lesson from the latter practice is: in other countries where the rule of non-recovery under illegal contract is

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[41] Vgl. Wagner, Prävention und Verhaltenssteuerung durch Privatrecht, AcP 2006, 352, 363 ff.

[42] Klöhn, a.a.O., AcP 2010, 804, 820 ff.

[43] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 32, ILLUSTRATION 11&12 (2011); Hartman v. Harris, 810 F. Supp. 82 (S.D.N.Y. 1992); The Highwayman's Case (Everet v. Williams), 9 L.Q.Rev. 197 (1893) (Exch. 1725); Clark v. United States, 102 U.S. 322, 26 L.Ed. 181 (1880); United States v. Kim, 870 F.2d 81 (2d Cir. 1989).

[44] In some studies, scholars even suggest that the application of the rule of *in pari delicto potior est conditio defendentis* be limited to performance that causes either grave violation of law, such as tort or crimes, or violation of *boni mores*. Honsell, Die Rückabwicklung sittenwidriger oder verbotener Geschäfte, C. H. Beck, 1974, S. 136 ff.

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adopted, there still exists exceptions allowing restitution, including restitution of benefits gained from property and added values. Thus it seems that Chinese Contract Law should to a greater extent take into consideration the regulatory purpose and other relevant factors when determining the scope of restitution. The following analysis will center on various factors which affect whether to allow restitution after the invalidation of illegal contracts and attempt to generalize the main rules that regulate bad-faith behaviors.

1. Purpose of Law

(a). The balance between purpose of law and regulation of bad-faith behaviors

To determine whether parties can seek remedy after their illegal contract is invalidated, examination of the purpose of law (Schutzzweck) is the "primacy of statutory purpose."[45] When examining whether the purpose of law prohibits restitution, the first step is to determine what the statutory purpose entails, which relies on interpretation of the law. Under the circumstances where disallowing restitution helps achieve the purpose of law, the next step is to determine whether such prohibition would produce other social impacts, undermine fairness, encourage bad-faith behaviors and prevent the achievement of other statutory purpose.[46]

In most circumstances, the purpose of law is rather clear, and it is relatively straightforward to determine the relationship between invalidation of the contract and restitution. For instance, in the case of violation of minimum wage law, the employer and the employee voluntarily entered into a labor contract that paid the employee below the minimum wage, and the employee later demanded the employer to pay him according to minimum wage standard. Under such circumstance, even though the labor contract is invalid and paying the employee beyond the minimum wage standard (higher than what was promised in the contract) contradicts the good-faith principle, the Court still should support the employee's claim, given the fact that the exact purpose of minimum

[45] See Restatement (Third) of Restitution & Unjust Enrichment § 32 comment c (2011); MüKo/Schwab BGB § 817 Rn. 20–29b.

[46] Legally unrecognized status (transfer of property) should not be legitimized by the rule of *in pari delicto potior est conditio defendentis.*" BGH NJW 1990, 2542; Palandt/Sprau, § 817 Rn. 18, § 812 Rn. 70 BGB.

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wage law is to prevent employees from "voluntarily" accepting wages below the minimum standard.

However, it is not an easy task to balance different purposes of law in some particular instances. In the case of "black labor contract," the employer and the employee entered into a contract of employment overseas, which stipulated that the employee would work at the employer's restaurant located at the latter party's home country (in New York for example) and the payment was 300 dollars per month. Both contracting parties were aware of the fact that the employee's visa did not permit him to work at the employer's home country. The employer paid the employee travel expenses and provided food and accommodation during work, but refused to pay him wages as promised except for occasionally giving the employee small amounts of cash. Later on, the employee sued the employer, requesting to be paid as promised in the contract or pursuant to the local minimum wage standard. The employer contended that the illegality of the contract precluded enforcement. The purpose of prohibiting black labor in such dispute is to maintain the order of labor market and the controlling immigration in one country. However, such prohibition might undermine contractual fairness, deprive employees of protection, and encourage bad-faith behaviors. Some Courts in China have taken into consideration these effects of such prohibition when approaching the problem. The following case is such an example.[47] Mr. Zhong worked for a company as the administrative manager, but he was a Hong Kong resident and did not hold work permit for Hong Kong, Macau and Taiwanese residents. Later Mr. Zhong requested the company to pay his wages earned September 2011 and April 2012, and demanded double compensation for delay of payment. The trial court rejected Mr. Zhong's claim, holding that 1) he was not under the protection of Labor Law since he failed to obtain work permit and 2) he had been an administrative manager in this company for years and should have understood the serious consequences of working without the work permit for Hong Kong, Macau and Taiwanese residents. The appellate court, on the contrary, supported Mr. Zhong's request for wages based on the consideration for substantive justice, namely, which is to protect employees in this case (but

[47] 钟某诉江门市某纺织有限公司劳动合同纠纷上诉案 [Zhong v. Jiangmen Fangzhi Ltd. on Labor Contract Dispute] (2013)江中法劳终字第787号, (Guangdong Jiangmen Interm. People's Ct. Dec. 02, 2013) CLI.C.2143318 CHINALAWINFO.

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did not support his claim for double compensation and other damages).[48]

Chinese courts take a rather lenient approach to this problem and allow employees to claim their wages that they deserve. Then one question should be answered: is this due to the fact that Chinese Contract Law does not have the rule of non-recovery under illegal contract? To put it another way, does such claim tend to be rejected in countries that adopt the rule of non-recovery under illegal contract? The answer is negative. In American law, the Restatement (Third) of Restitution & Unjust Enrichment holds the following opinion regarding this issue: according to immigration law, employers should not refuse to pay wages after using illegal employees; namely, the employees' claim for wages should be supported, and the amount should be determined in accordance with the standard in the labor market; travel expenses, food and accommodation expenses and cash already paid should be deducted from the wages.[49] In German law, the Supreme Court in similar cases[50] held that the labor contract should be invalidated, and such invalidation already achieved the regulatory purpose. "According to the principle of good faith," "it would be unjust" to allow the employer free from paying corresponding consideration.[51] Namely, the rule of non-recovery under illegal contract stipulated in §817(2) does not apply in such circumstance.[52]

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[48] *See* 广东省高级人民法院、广东省劳动争议仲裁委员会关于适用〈劳动争议调解仲裁法〉、〈劳动合同法〉若干问题的指导意见 [Advisory Opinions on the Application of Labor Dispute Mediation and Arbitration Law and Labor Contract Law by Guangdong High People's Ct. and Guangdong Labor Dispute Arbitration Commission] (promulgated by Guangdong High People's Ct. and Guangdong Labor Dispute Arbitration Commission, Jun. 23, 2008, effective June 23, 2008) art. 18,.

[49] See Restatement (Third) of Restitution & Unjust Enrichment § 32, illustration 3 (2011); Nizamuddowlah v. Bengal Cabaret, Inc., 92 Misc.2d 220, 399 N.Y.S.2d 854 (Sup.Ct. 1977).

[50] See BHGZ 111, 308.

[51] BGH NJW 1980, 452; Larenz/Canaris, Lehrbuch des Schuldrechts, Bd. II/2 Besonderer Teil, § 68 III 3 e).

[52] It is worth noting that as the European integration process advances, Germany is increasingly facing the problem of a large volume of illegal foreign labor. Against this backdrop, the mainstream scholarly opinion In Germany holds that the Supreme Court's decision is improper. The Court, instead, should strictly apply §817(2) to ensure that employees are not entitled to claim restitution of compensation corresponding to their labor. Armgardt, Die zweite Schenkkreisentscheidung des BGH als Ausgangspunkt für einen

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It can be seen from the empirical cases above that contrary to common knowledge, the rule of non-recovery under illegal contract has considerable flexibility. It excludes protection of illegal behaviors on one hand and sets necessary exceptions on the other.[53] Those exceptions, to a great extent, are set up out of consideration for ensuring fairness and deterring bad-faith behaviors.

(b). Principle of proportionality

As mentioned earlier, it is difficult to deny that private law has the function of regulating parties' behaviors and preventing illegality. Just as Criminal Law and Administrative Law stress on the principle of proportionality between conduct and punishment, private law should also take into account the same issue if it is to deprive parties the right to claim restitution.[54] If the person merely engages in an illegal conduct of minor degree and the law denies protection in the manner of stripping property rights, such form of punishment might be overly severe.[55] Moreover, if the party has already been imposed criminal or administrative penalty, the imposition of civil penalty on top of that is very likely to incur double jeopardy.

According to the above analysis, the rule of the US Restatement (Second) of Contracts can be verified: in principle, the party of the illegal contract is not entitled to request for restitution, unless such exclusion of restitution will lead to "disproportioned forfeiture" (§ 197). In the example designed to illustrate this point[56], B entered into a contract with a foreign company A for purchasing goods of 10 million dollars. Although A has delivered the goods, he violates a regulation regarding forbidding foreign companies trading like this without authorizing a middle man. Additionally, according to that regulation, related contracts cannot be enforced

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Paradigmenwechsel im Hinblick auf die Auslegung von § 817 S. 2 BGB, JR 2009, 177 (Fn. 18).

[53] Vgl. Reuter/Martinek, Ungerechtfertigte Bereicherung, 1983, § 6 V 1 a (S. 203); Reeb, Grundprobleme des Bereicherungsrechts, 1975, S. 66; Klöhn, a.a.O., AcP 2010, 804, 808–809.

[54] Vgl. BeckOK BGB/Christiane Wendehorst BGB § 817 Rn. 20-22 (Verhältnismäßigkeit).

[55] See Law Commission of England & Wales, Illegal Transactions: The Effect of Illegality on Contracts And Trusts (Consul. P. No. 154), 1999, para. 7.42.

[56] See Restatement (Second) of Contract § 197 illustration 4 (1982); Dunlop v. Mercer, 156 F. 545 (8th Cir. 1907); Fields v. Hunter, 368 A.2d 1156 (D.C. Ct. App. 1977).

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mandatorily. The author of the US Restatement (Second) of Contracts thinks that even though A has no right to claim for payment, denying A's recovery under illegal contract would lead to "disproportioned forfeiture." Therefore, the contract was void and null, but the court should still support A's requests for returning goods or equal payment. In another example[57], Company B entered into a contract with City A, promising to install transport signal equipment for A and charging A for 50000 dollars. However, A failed to comply with regulations regarding the procedure of government contracting for purchase, so this contract in dispute was null and void. Knowing this fact, B still installed the equipment. Whether B could request A to pay for the equipment? In light with Restatement (Second) of Contracts, the court should consider the proportionate relationship between the "deprivation" consequence of the denial of restitution and public policy, apart from the degree of severity of violating public policy.

One of the goals of balancing ends and means is to lessen conflicts between regulating objects that the law intends to realize and protect good faith. On some necessary occasions, legal objects are so important that good faith or trust will be at expense. In another case of the US law, a law forbids devastation of wet land and imposes criminal punishment for any violation. An engineer and wet land owner contracted to dry a large portion of wet land, which violated the law. Facing the risks of being punished, the engineer asked for higher price: instead of reasonable price for the labor and materials which was 50,000 dollars, they agreed 100,000 dollars for the contractual payment. Besides, after the completion of the project, the value of wet land increased to 150,000 dollars. Then, the wet land owner refused to pay based on the fact that this contract violated the law. The court thinks, although wet land owner was unjustly enriched, the engineer's request should not be supported because monetary restitution would encourage what was forbidden by law.[58] After balancing these different interests, the court obviously put wet land protection in a more crucial position.

The proportionate relationship between ends and means

[57] See Restatement (Second) of Contract § 197 illustration 5 (1982); Edwards v. City of Rendon, 67 Wash. 2d 598, 409 P. 2d 153(1965); Blum v. City of Hillsboro, 49 Wis.2d 667, 183 N.W.2d 47 (1971).

[58] See Evans v. Luster, 84 Wash.App. 447, 928 P.2d 455 (1996).

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manifests more apparently in the distinction between legal regulations on illegal medical treatment and architecture qualification: although these two regulations have the function of protection of public interests, the former involves personal safety, which is more important. Hence, even if the illegal medical practitioner contributes his labor, his monetary restitution usually cannot be supported.[59] For instance, in the example of the US Restatement (Third) of Unjust Enrichment, a pre-paid 2000 dollars to B for a series of medical treatment. After going to B's office twice, A knew B had no medical qualification. Thereafter, A asked B to return his prepayment, which is supported by the court.[60] In another Chinese case[61], plaintiff went to B for medical treatment because of burn injuries. The court considered that Defendant failed to get permission from health administrative department as well as obtain the medical qualification, which is regarded as illegal medical practice and violation of mandatory rules. Thus, "the medical contract between the plaintiff and defendant was null and void, so accordingly Defendant should return RMB10,600 to Plaintiff." However, in cases which lack construction qualification, the interests involved is specific property interests. If the quality of the construction meets the standard, the interests of the constructor should be protected. In the US law, if constructor fulfills its contractual duty, the request for payment usually is supported (or the Employer's request for return of payment is denied[62]). Chinese law regulates that construction contract is invalid, but the court still supports Contractor's requests for payment.[63] This arrangement in effect not

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[59] As for illegal medical practice, German law strictly applies the second sentence of § 817 BAG NZA 2005 which forbids doctors' requests for restitution (when he already performed the value of the contract). BAG NZA 2005, 1409; Staudinger/Lorenz, 2007, § 817 Rn. 10 BGB.

[60] See Restatement (Third) of Restitution & Unjust Enrichment § 32 illustration 21 (2011); Nizamuddowlah Rubin v. Douglas, 59 A.2d 690 (D.C. Ct. App. 1948); Deaton v. Lawson, 40 Wash. 486, 82 P. 879 (1905).

[61] 徐玉红与杜银龙医疗服务合同纠纷 [Xu Yuhong v. Du Yinlong on Medical Service Contract] (2012)冠民初字第1814号, (Shandong Guan County People's Ct. Jan. 22, 2014) CLI.C.5362576 CHINALAWINFO.

[62] *See* Restatement (Third) of Restitution & Unjust Enrichment§32 illustration 6(2011); Farel v. Whiteman， 146 Idaho 604, 20P. 3d 1153 (2009); Charlebois v. J.M.Weler Asociates, Inc., 72N.Y.2d 587, 535 N.Y.S. 2d 356，531 N. E. 2d 1288(1988).

[63] *See* 最高人民法院关于审理建设工程施工合同纠纷案件适用法律问题的解释 [Interpretation of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases of Dispute over Contracts on Undertaking Construction Projects] (promulgated by the Sup. People's Ct., Oct.25, 2004,

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only encourages honoring contract but also prevents breaching the trust.

2. The Degree of Severity of Illegality

As previously discussed, although first sentence of Article 58 of Chinese Contract Law regulates recovery under illegal contract, it does not apply to all cases. Taking smuggling of weapons, bribing or taking bribe and gambling as examples, if one party claims for restitution based on the first sentence of Article 58 of Chinese Contract Law, even if the government does not forfeiture the money involved, the court obviously would not support the claim such as request for gambling debt. In this sense, though there is no exception explicitly stipulated to the general rule of restitution, its application in practice is de facto limited. The degree of severity of illegality directly influences whether there is restitution or not. Relying on this rule, when degree of illegality is severe, good faith or trust (Treu und Glauben) or justice (Billigkeit) cannot overwhelm the necessity of punishing illegality.[64] At this point, it is unnecessary to consider whether ends and means are proportionate. Nevertheless, when the degree of severity is less, such as tax fraud or failure to give invoices when providing/accepting services, the contract might be null or void, but the contractual rights of both parties would not be affected. The consigner can still require consignee to take quality warranty liability with reference to unjust enrichment.[65]

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effective Jan. 1, 2005) CLI.3.55723 CHINALAWINFO. In the situations that "the contractor has not been eligible as a construction undertaking enterprise or is in excess of the eligibility grade, an ineligible actual construction undertaker works in the name of an eligible construction undertaking enterprise and the construction project must be under bid invitation but no bid is invited or the bid is invalid", the contract shall be invalidated. However, although the contract is invalid, if "the construction project is inspected at the time of completion to be qualified", then "the contractor's request for payment of the construction cost by considering the contractual stipulations for reference shall be sustained". The sustention does not explicitly point out the claim basis. Some people in legal practice call it "deeming invalid, dealing valid". In the framework of this article, the nature of this claim basis is unjust enrichment, but the amount of the restitution shall be based on construction cost agreed in the contract, which not only includes the actual expense of the constructor of this construction project, but also includes the possible revenues generated from this project.

[64] Vgl. Staudinger/Lorenz, 2007, § 817 Rn. 10 BGB.

[65] Vgl. Lorenz, „Brauchen Sie eine Rechnung?": Ein Irrweg und sein gutes Ende, NJW 2013, 3132.

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Taking the case Tinsley v. Milligan of the English law (the defendant and plaintiff bought a house together, but registered that house under one of their names. The defendant now claimed the rights of the house.) as an example, the court thinks, now that the purpose of the party to register the house under the plaintiff's name was to extract more social insurance money form the Social Security Department of the nation, its illegality is not severe. It would be inconsistent with ordinary consciousness if depriving the defendant's rights of the house. On the contrary, if the parties did this real estate entrustment for better conducting terrorist activities, then the law would limit the protection of defendant.[66]

Similar to English law, in the US law, the degree of severity of illegality will also influence restitution. In the exemplary case of US Restatement (Three) of Unjust Enrichment, A and B formed a partnership for acquiring and selling stolen goods. Partners agreed on equally dividing profits. B sold a good stolen by A with a handsome profit, but he did not share that profit with A. A sued B for returning his part of profits, but it involved crimes and A's conduct was inappropriate. Therefore, the claim for restitution was not supported.[67] In another exemplary case, A paid B 5000 dollars as consideration for purchasing 50000 dollars' worth of fake money. B failed to fulfil his contractual duty. The court also did not support A's claim for restitution because of A's inappropriate conduct, although B defrauded and gained unjust enrichment.[68]

The standard of "the degree of severity of illegality" helps balancing other commonly seen breach of trust. For example, in contract disputes of homestead in rural area which is discussed previously, the major issue among parties is the seller requires the court to find the contract is null and void and, therefore, takes back the house. The increasing value of the land motivates the seller to gain more profits. From the standpoint of law, given that China has maintained the urban-rural dualistic economic structure for a long time, the current regulation regarding similar deals remains unclear. However, as for our public policy, the effect of these deals is denied constantly and unswervingly. When judging the consequence of in-

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[66] *Supra* note 55, at 104.

[67] *See* See Hartman v. Harris, 810 F. Supp. 82 (S.D.N.Y. 1992); The Highwayman's Case, (1893) 9 L.Q. Rev. 197 (Exch.).

[68] *See* Chapman v. Haley, 80 S.W. 190 (Ky. Ct. App. 1904).

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validity of these illegal contracts, the degree of severity of illegality should be considered further. If the violation does not fundamentally harm the big picture of national economy. In this sense, The Higher People's Court of Beijing Municipality issues the Meeting Minutes on Seminar on the Effect Recognition of Contract Dispute of Private House in Rural Area and its Dealing Principle, which states that "thorough consideration should be given to influence on the interests of parties when the contract is null and void, especially when the land value increases and the land is removed and the owner is compensated, as well as the loss suffered by the buyer caused by the difference between the present value of the said house and its original price." It is an innovative rule, which also complies with restitution based on unjust enrichment rule (though there is still room for further development to protect the interests of the buyer more comprehensively).[69]

In addition, taking foreign-investment enterprise investing in internet operation as an example, when foreign funded enterprises apply for online "Electronic Data Interchange (Commercial E-business)" investment license, Chinese law[70] used to limit the foreign shareholding proportion. In order to avert this limit and materialize channeling in foreign capital market, many enterprises adopt the VIE model, which enables foreign investors to control domestic enterprises by private agreement instead of share ownership. Obviously, this arrangement violates regulations and rules at that time. It is possible to be deemed as invalidity. Under the analytical framework of this article, even though the related controlling agreements are deemed invalid, the severity of such illegal conducts should be taken into consideration, including the necessary foundation of market regulation and profound development of policy[71], etc., so as to protect legal interests of investors by restitution.

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[69] See *supra* note 1, at 225 (explaining about the disputes regarding the breach of trust in the sales of rural homestead).

[70] Including Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, the Catalogue of Industries for Guiding Foreign Investment, Provisions on the Administration of Foreign-funded Telecommunications Enterprises, etc.

[71] For example, according to Notice of the Ministry of Industry and Information Technology on Removing the Restrictions on Foreign Equity Ratios in Online Data Processing and Transaction Processing (Operating E-commerce) Business in June, 2015, it loosens the regulations on the shareholding percentage of foreign entities and allows foreign entities in this area hold 100% shares.

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Especially, under some circumstances, restitution should be not excluded when this conclusion is drawn for the analysis of legal intent and public policy, even though the said conduct is related to crime. In an exemplary case of the US Restatement (Third) of Restitution & Unjust Enrichment[72], a lawyer advised his client to give a false testimonial statement, provide perjury and bribe witnesses in return for compensation from the client. The client followed this advice but it turns out that this conduct increases his criminal responsibility. Now the client requested for restitution for this payment. Given that the client's request is based on inequitable conduct of himself, he cannot request for restitution according to Restatement (Third) of Restitution & Unjust Enrichment § 32(3). However, if the policy consideration of the law regarding deprivation of illegal income of lawyers require to deprive such kinds of income, the restitution claim of the client should be supported in line with Restatement (Third) of Restitution & Unjust Enrichment § 32(1). This section states that restitution will be allowed, whether or not necessary to prevent unjust enrichment, if restitution is required by the policy of the underlying prohibition.[73]

3. Parties' Subjective State in Dispute on Illegality

(a). Clean hands doctrine

The system of restitution based on unjust enrichment stems from "in pari delicto potior est conditio defendentis" rule of Rome Law, which means that if both parties have faults on the illegality of contract, then the restitution claim of Plaintiff cannot be supported. As the effect of the system of possession, the said property should remain in hands of Defendant or the possessor. A similar rule in English Equity is the so-called "clean hands doctrine": Plaintiff is not entitled to obtain an equitable remedy because Plaintiff is acting unethically or has acted in bad faith with respect to the subject of the complaint. This rule comes from daily life of ordinary people, so it might be applied to Chinese law. Nevertheless, two points must be taken into consideration: first, as stated previously, if both parties have faults, the clean hands doctrine is

[72] *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 32, ILLUSTRATION 4 (2011); Feld & Sons, Inc. v. Pechner, Dorfman, Wolfee, Rounick and Cabot, 458 A.2d 545 (Pa. Super, Ct. 1983).

[73] "Restitution will be allowed, whether or not necessary to prevent unjust enrichment, if restitution is required by the policy of the underlying prohibition".

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not applicable conclusively because of other considerations. For example, when the illegality is not severe enough, the interests of one of the parties should be considered to be protected. In reality, *in pari delicto potior est conditio defendentis* in Rome Law can mainly apply to those "non-contractual" (außervertragliche) or other unusual situations of nominated contracts (such as hiring killers, bribing judges, etc.).[74] Second, it is a key point to judge that whether both parties have mutual and common faults when applying this rule. Under some circumstances, if one or both parties are unaware of the status of illegality, there is still room for restitution of his rights. For instance, one possible situation is that, when one regulation to forbid transactions is just carried out, both parties are unfamiliar with this rule. In this situation, it should not simply make the reference that "this law has already been publicly known." Third, when the interests and rights of parties in dispute are not gained from illegal conduct (for example, in the case of Tinsley v. Milligan discussed previously, Defendant originally and legally was entitled to the ownership of the house. His illegal conduct lies in the fraud of social security department in order to gain more insurance benefits.), then his rightful claim for restitution should be supported.[75]

It is worth noting that except for illegality of the content of transactions, illegality of related conducts was mainly due to one party in some situations. For example, quite a lot of regulations focus on one party's legal qualification in this transaction as it is mentioned before that construction enterprises need certain qualifications, doctors need medical qualifications and banking, insurance businesses need legal permissions. If one party does not have such qualifications to conduct certain business, the other party might not be familiar with the existence of illegality and it would be difficult for him to find out after due diligence. Under such situations, the reason why the contract is null and void is not because both parties break the law, but one party defrauded the other party in terms of qualification. Therefore, even though the contract is invalid, in principle the law should protect the interests of the other

[74] Vgl. Honsell, Die Rückabwicklung sittenwidriger oder verbotener Geschäfte, C. H. Beck, 1974, S. 86.

[75] Tinsley v. Milligan, [1994] 1 A.C. 340 (H.L.) 371–72 (appeal taken from Wales) ("...establish his equitable interest in the property without relying in any way on the underlying illegal transaction.").

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party, not only for restitution from unjust enrichment but also compensation for damages.

(b). Repentance and discontinuation of illegal conduct

From the perspectives of Criminal law and Administrative law, if the actor repents before he conducts illegal and criminal actions, it is the preventive effect of law. It is necessary to encourage such repentance.[76] Accordingly, Rome law has stipulated locus poenitentiae for a long time: if the actor discontinues the performance of the illegal contract, even though the contract is illegal, the discontinued actor can still require restitution for his performance.[77] For example, when authorizing others to carry illegal conduct such as hiring to kill, if consigner asked the consignee to abort and killing and return "payment" before the murder and after the instruction, it is legitimate to support the consigner's request for restitution. For the above arrangement, Flume, German scholar, raises a point in dogmatic of law (Rechtsdogmatik) that under property transfer based on entrustment/authorization relationship circumstances, if there is no actual illegal conduct, even though the entrustment and authorization contracts breaks the law, such illegality does not contain withdrawal of rights for parties to repeal the entrustment and authorization based on this contract. If the consigner repeals the authorization, then the reason for illegality has vanished due to this revocation. Its request for restitution is not based on illegal reason, so the law should support this request.[78] This claim ought to be taken into reference under the dogmatic of law and also can be applied in the Article 410 of Chinese Contract Law (The principal or the agent may rescind the commission contract at any time).

4. The Content of Enrichment

According to the rule of no restitution for illegal enrichment, it is unnecessary for the actor to return the gains of the transaction. But a question that worth consideration is that what is the "benefits based on the transaction" of the actor. Taking sales contracts as an example, after the performance of contract, what the buyer gains is

[76] *See* Irit Samet, Locus Poenitentiae: Repentance, Withdrawal and Luck, in CONSTRUCTIVE AND RESULTING TRUSTS 335–68 (C. Mitchell, ed., 2010).

[77] *See supra* note 17, at 16-181.

[78] *See supra* note 37, at 471.

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the ownership of the subject matter of the contract. For example, in gun selling transactions, the "benefits" of the buyer is the gun. In accordance with the rule of no restitution for illegal enrichment, there is no restitution for ownership of the gun (for argument's sake: no need to consider whether the gun might be forfeited by the government). If both parties sign a lease contract, given that the ownership of the house has not been transferred to the lessee, "benefits" at best mean the usage and proceeds of this house during the lease term, not the ownership of the house. Likewise, this can be applied to loan contracts which are similar to lease contract. Taking usurious contracts in German law as an example, although law stipulates usurious contracts violates good custom so as to be null and void (BGB § 138(2)), the "benefits" of this transaction is interests, not the sum of interests of principle because the transfer of principle is just temporary but not terminal.[79] Hence, when the contract expires, at least the request for restitution should be allowed (in Chinese law, the solution of this question focuses on the validity of the contract, states that the agreement regarding the interests is invalid, but the loan contract itself is valid, so the obligator should still pay market interests.)[80]

D. Summary

Unlike other rules in private law, the system of illegal enrichment is less determinate for the reason that a sufficient balancing among the factors like legal purpose, the degree of illegality, subjective state of parties is needed when it is used to deal with the

[79] As for the problem of the restitution after the usurious loan, there are three different propositions in German law: the first one is the borrower does not need to pay his loan (supported by cases such as RGZ 161, 52; RGZ 151, 72; Honsell, Die Rückabwicklung sittenwidriger oder verbotener Geschäfte, C. H. Beck, 1974, S. 21); second, he needs to pay the principles; third, he needs to pay market interests. One of the counterclaims against the first proposition is that the gains are understood as the sum of the interests and the principle, so the conclusion of completely no restitution is drawn. By doing so, apart from the injustice, it will encourage one party (the borrower) to breach the trust by using this rule to gain illegal benefits. If the market interest is supported, then it would not be helpful to realize the regulatory goal. In this sense, the arrange of only returning the principles with no interests would be a win-win situation. See Gerhard Wagner, Prävention und Verhaltenssteuerung durch Privatrecht -- Anmaßung oder legitime Aufgabe [Prevention and Behavioral Control Through Private Law – Presumption or Legitimate Task] 206 Archiv für die civilistische Praxis (AcP) 352, 368 (2006) (Ger.); See also supra note 37, at 465.

[80] OLG Dresden SA 59 Nr. 81 (S. 144).

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recovery under illegal contracts. In fact, as mentioned above, even in the context of German law's extreme emphasis on determinacy, its rule on illegal enrichment is also in a relatively vague state. The code commentaries, for example, besides specified some abstract expressions such as the "legal purpose" and "the direct principle of illegal behaviors" as the basis for restricting application of illegal enrichment, it also intends to discuss the restitution of illegal enrichment centering on the types of behaviors, including loan, service, transaction, commission, bribery, etc.[81] However, there are many internal conflicts in this type-oriented discussion. First of all, the same type of contract is treated or disposed differently in different historical periods. For instance, usurious contract in the early time had not been required to return the principal and interest, while the principal could be claimed for return later. Secondly, even within similar legal relationships, different transaction contents are also treated distinctly. Taking the sales contract as an example, the buyer of firearms shall not ask the seller to bear the obligations of quality assurance, while the sale of "electronic dog" has experienced a transformation, in which the buyer could advocate seller's quality assurance obligations though initially incapable of doing that. For another case in rendering service, illegal medical practitioners may not request for the considerations of the service (the corresponding value). However, in illegal labor contracts, labors without work license can require the return of equivalent value of their service (definitely not the remuneration agreed in the contract). Commission or trust contracts are flowed by, for instance, the consignor in contract killing cannot request the return for remuneration, while people who commit others to escrow the account for tax evasion can claim for restitution. It is in this context that the system of illegal enrichment was called as the bewegliches system by scholars.[82]

Perhaps for this reason, the final solution proposed by the British Law Commission in its nearly two hundred report was to give judges the discretion in this case.[83] This article considers that this is not a shirking of responsibility or even meaningless advice,

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[81] MüKo/Schwab BGB § 817 Rn. 35 ff.; Studinger-Lorenz, 2007, § 817 Rn. 12–23.

[82] D.KÖNIG, UNGERECHTFERTIGTE BEREICHERUNG: TATBESTÄNDE UND ORDNUNGSPROBLEME IN RECHTSVERGLEICHENDER SICHT [UNJUSTIFIED ENRICHMENT: FACTS AND PROBLEMS OF ORDER IN A COMPARATIVE PERSPECTIVE] 146 (1985) (GER.).

[83] See *supra* note 55, at 39.

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but rather a prudent choice based on respect for objective reality. Experience tells that the perfect solution to the invalidation of illegal contract, whether it is in the first stage to evaluate the validity of contract or the second stage to discuss the consequence after the contract is invalid, depends on the integration and balancing of relevant factors. Instead, simple and arbitrary conclusion cannot fully coordinate the parties' interests and respond to trading realities. The deficiencies of existing precedents and theories are not located in not implementing such discretion or ignoring its importance. The real problem is that we didn't identify the proper basis or carrier to conduct such discretion and in particular the failure to carry through the idea of regulating bad faith behaviors. In contrast, by reducing the discretion on the validity of contract and adjusting parties' interest through restitution is more helpful to achieve the balance between the authority of law and the interests of parties. The current law on the recovery under illegal contracts is unduly rigid and has a vague basis of claim, therefore limiting discussions in the second stage and burdening the first-stage argument with more logic leaps.

V. Regulating the Interpretation and Improvement of Illegal Contract System within the Bad Faith Context

The above contents of this paper based on the system of invalidation of illegal contract with the focus on the relationship between "Regulation and Bad faith" argues that some of the specifications invalidating the contract based on the purpose of regulation may cause the consequence of encouraging bad faith behavior. Therefore, it is necessary to design different restitution rules treating invalid contracts to resolve the conflicts between regulation and good faith. In general, there are still many questions needed further responds, for instance, when the parties are doing illegal transaction, is it the same for the connotation of good faith in this illegal transaction comparing that in legal transactions. In other words, when the transaction was illegal, there is no need to talk about good faith. In addition, under circumstance that illegal transactions accounts for a small proportion of total transactions, will it cause damage to foundation of social trust for not regulating the bad faith under illegal transactions.

In the analytical framework of this article, trust or good faith is a neutral concept, and also an assurance that one party will com-

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ply with the forward commitment. Therefore, it is not directly related to the parties' transactions. In other words, either in legal transactions or knowingly illegal transactions, good faith in such kind of nature may exist. It's emphasized that the design of different recovery rules based on the protection of good faith or trust is not intended to negate the evaluation basis for legality, but rather to adequately respond to the complicated interests involved in regulation. That is to day, the illegal transaction itself may have a variety of meanings and breaking the law doesn't mean that parties' rights shall not be protected at all, in particular, cannot be a legitimate basis for others' enrichment. In fact, the existing law has long been aware of the complex relationship after the invalidation of illegal contracts.

A. Reinterpretation of the Damage under the Illegal Contract

In the interpretative theory and positive law level, China's judicial practice has made efforts to apply the existing norms flexibly and coordinated the relationship between regulation and good faith. As mentioned above, the parties are generally or presumably aware of law requirements, and therefore parties' degree of fault shall be the same. If so, the second sentence of Article 58 in Chinese Contract Law is not applicable when the contract is invalid as it stipulates that "The party at fault shall compensate the other party for losses incurred as a result." However, in practice, the judgment for holding one party to compensate the other party for his loss is very common. In a case for example[84], the plaintiff bought a social security house borrowing the name of the defendant. Then the contract was confirmed as invalid and the defendant obtained housing ownership. The court of first instance held that the defendant should compensate the plaintiff at the amount of 50% of the added value of the house. However, the court of second instance found that, the trial court's judgment was an improper law application as the court identified that plaintiff and defendant had equally fault in the arising of disputes. Therefore, the court of second instance corrected previous judgment and held that defendant in this case shall

[84] 魏小芳与杨焕芹合同纠纷案 [Wei Xiaofang v. Yang Huanqin on Contractual Dispute] (2014)一中民终字第2736号, (Beijing First Interm. People's Ct. Jul. 19, 2014).

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bear more responsibility for compensation.[85] The problem of this type of verdict is that the amount of compensation shall be based on the judgment of parties' degree of fault, which lacks theoretical basis, therefore is questionable and often not precise enough.[86] Under this article, such damages in nature are still belong to the recovery of unjust enrichment (including parties' proceeds from the contract), which will enable parties' legal status revert to the state after fulfillment of the contract and before the parties' mutual restitution.[87]

B. The Guarantor Shall Bear the Recovery Obligation under

[85] In the series cases of painter village of Beijing Songzhuang, one of the judgments states that since the seller was fully aware that the house and homestead sold were forbidden from land circulation, he should bear the primary liabilities even if he still claimed the contract to be invalid on the grounds of the illegal transaction many years ago. For buyer's reliance damage, it shall be based on a comprehensive consideration of two aspects: seller's enrichments due to land appreciation or demolition and compensation and buyer's loss of price which is the variation between the current value and original contracting price; see 北京画家村房产买卖纠纷案 [In re the Contractual Disputes on Painter Village of Beijing Songzhuang] (2007)二中民终字第13692号, (Beijing Second Interm. People's Ct. Dec. 27, 2007). This judgment was worthy to be affirmed or partly affirmed although it is questionable that the court targets the aspect of reliance damage.

[86] Professor Han Shiyuan considered this damage as the liability of contracting fault. *See supra* note 13, at 229. As stated above, when both parties are aware of the illegal conducts, it is hard to prove the negligence of one party to the other.

[87] In another case, the plaintiff obtained a qualification to purchase an economically affordable house which was conditioned upon the registered residence in Beijing. The defendant proposed to lend her identity card to the plaintiff to process purchasing formalities since the defendant didn't have the plan of house purchasing herself. The parties agreed to transfer the house for plaintiff after 5 years. After the delivery of the house, the plaintiff has decorated the house and resided there till the date of dispute. The court held that the unqualified family's purchase of economically affordable housing in the name of others violated the State's prohibitive regulations and should be deemed as invalid. However, when both of the parties were at fault for the consequence of illegal contract and the defendant was even more responsible, the allocation of the added value of the disputed housing followed the discretionary judgment, which the defendant received 30% of the appreciation and the rest 70% returned to the plaintiff; see 孙桂华等与孙桂亭合同纠纷案 [Sun Guihua v. Sun Guiting on Contractual Dispute] (2013)昌民初字第10428号, (Beijing Changping Dist. People's Ct. Mar. 27, 2014). Compared to the previous judgment, the latter uses the word "return" although the two cases share the same facts.

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Illegal Guarantee Contract

In China, loans and related guarantees are the areas in which the bad faith behaviors are flooded.[88] The rule of non-recovery under illegal contract and its exceptions can better explain and adjust the legal consequences of the invalid guarantee contract. In the case published in the Communique of the PRC Communique of the Supreme People's Procuratorate between the Red River Company and the Chongqing Jingwei Pawnshop[89], the court of retrial considered that pawnshops could only engage in hypothecated loans instead of engaging in mortgage loans. So the loan agreement as the main contract in this case was invalid, causing the collateral mortgage contract invalid as well.[90] The creditor may obtain the principal and interest calculated based on legal interest rate but not the mortgage right.

In the above mentioned case, the conflict between good faith and regulation has reached to the extreme. Initially providing of collateral for creditors is the real intentions of the mortgagor (and also the debtor), however, through the arrangement of invalid con-tract, the debtor can get the loan without bearing the guarantee re-sponsibility. This result is likely to mean that creditor's claim can-not be achieved if the debtor is in an insolvent state. Such a case has a huge impact on people's consciousness. It's believed that the prosecutors and court for retrial cannot successfully answer the fol-lowing questions, including (1) if the law does not prohibit the in-dividual from lending its own funds requiring mortgage guarantees,

[88] 黄忠 (Huang Zhong), 企业间借贷合同无效论之检讨 [Discussion About the Theory on the Invalidity of Inter-Company Loan Contracts], 清华法学 [TSINGHUA LAW JOURNAL], issue 4, at 144–45 (2013).

[89] 重庆经纬典当行诉重庆红河物业发展有限责任公司、重庆市渝北区龙溪通用材料经营部、重庆春益房地产开发有限公司借款合同纠纷抗诉案 [Chongqing Jingwei Pawnshop v. Chongqing Red River Property Company Limited, Business Department of Longxi General Materials in Yubei District, Chongqing, and Chongqing Chunyin Real Estate Development Company Limited on Loan Contract Dispute] (2001)渝高法民再字第141号, (Chongqing Higher People's Ct. Apr. 30, 2003), 最高人民检察院公报 [PUBLIC REPORT OF THE SUPREME PEOPLE'S PROCURATORATE], issue 3, at 27-30 (2004).

[90] Article 3 of the previous 典当行管理暂行办法 [Interim Provisions on the Administration of Pawnshops] (promulgated by the People's Bank of China, Apr. 3, 1996, effective Apr. 3, 1996) stipulated that the pawnshop is a special financial enterprise that provides temporary hypothecated loans in the form of transferring the possession of entities for non-state, small-and-medium-sized enterprises. Article 25 stipulated that the pawnshop's engagements in hypothecated loans are limited to its own funds.

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why should it control pawnshops by using their own funds for external loans? In fact, soon after the retrial, the Measures for the Administration over Pawning in 2015[91] no longer prohibit the pawnshops from mortgage lending. Since the focus of financial regulation is the deposit business, excessive interference on the own-funds lending is not necessary. If this is to be determined, the validity of the loan contract and the guarantee contract is not influenced by the Interim Provisions on the Administration of Pawnshops. (2) Taking a step back, if the loan contract and guarantee contract are deemed to be invalid for violating of laws, then, whether there is still room for the application of restitution rules under the first sentence of Article 58 in Chinese Contract Law.

In a considerable number of loan guarantee arrangements, loans and guarantees are the mutual conditions or considerations. If it is interpreted that the debtor can freely recover its collaterals or erase the burden on collaterals at no cost when the contract is invalid[92], the rule of restitution will be substantially undermined when the creditor shall return the security or collateral and the debtor is not required to return the loan (the invalidity of the guarantee often means the loan right cannot be achieved.) It can be seen that the application of the restitution rule and the defense of simultaneous performance (deletion of recordation and the loan repayment constitute the defense of simultaneous performance) will be more in line with the concept of fairness and will in particular contribute to the encouragement of good faith and the regulation of bad faith. There is also room for guarantee provided by the third party. The third party guarantee itself does not change the fact that loans and guarantees are consideration between each other (note that due to the existence of the third party's recovery right to the principal debtor, theoretically the third party guarantee is not a gratuitous act). In other words, when the loan contract is deemed to be invalid for violation of regulatory norms, both the loan and collateral shall be recovered based on the restitution rules unless the third

[91] Article 25 of 典当行管理暂行办法 [Measures for the Administration] promulgated by the Ministry of Commerce and the Ministry of Public Security, Feb. 9, 2005, effective Apr. 1, 2005) stipulated that a pawnshop may carry out the following business operations upon approval: the pawn business of pledge of chattels...and the pawn business of mortgage of real estates.

[92] The mortgagor cannot claim the return of collateral based on ownership returning right when the mortgage contract was invalid. For the analysis on the system of non-recovery under illegal enrichment, see *supra* note 19.

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party expressed his intention under fraud or coercion. To say the least, even if the guarantee contract is considered as invalid for law breaking reason, the system of non-recovery under illegal enrichment should be applied on that basis, accordingly the guarantee doesn't have to return the collateral (or the guarantor has no right to request the guarantee to erase any related recordation). In the previous Red River Company case, the guarantee may retain its mortgage and realize its right no later than the issuance of the Measures for the Administration over Pawning in 2015.

Under the above analysis, the Judicial Interpretation of the PRC Supreme People's Court on Certain Issues Regarding the Application of the Security Law (the Interpretation) has stipulated guarantor's liability for invalid loan contract in Article 7 and 8.[93] However, the Interpretation in one hand failed to clearly distinguish between the invalid contract for law breaking and for other reasons, on the other hand, it also mistakenly relied upon the subjective elements to determine the scope of parties' liabilities. The latter mistake directly leads to the doctrinal misunderstanding of the nature of such rules including the theory of contracting fault[94] and the theory of tort.[95] The theory of contracting fault cannot explain why in the case of invalidation of illegal contract, there still exists the contracting fault by one party. Since the parties are aware of the illegal matters, it is not possible to enter into a contract with credulity or negligence. The theory of tort cannot justify that guarantor's behavior has reached an intentional level and violated the

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[93] Article 7: The guarantor and the debtor shall be jointly liable to compensate a creditor for any loss it suffers on the condition that the principal agreement to which the security relates remains valid notwithstanding the invalidity of the deed of security and the creditor is not at fault. Where the creditor and the guarantor are both at fault, the extent of the guarantor's liability shall not exceed half the value of the debtor's obligations that remain unfulfilled. Article 8: Where the guarantor is not at fault, he shall not assume any civil liability in relation to any security he has given that is invalid due to the invalidity of the principal agreement to which it relates. Where the guarantor is at fault, he shall be liable for no more than one third of the value of the debtor's obligations that remain unfulfilled.

[94] Earlier Researches include 王闯 (Wang Chuang), 对《关于适用<中华人民共和国担保法问题的规定》的理解 [My Understanding About the Interpretation of the Supreme People's Court of the Issues on the Application of the Guaranty Law of the People's Republic of China], 法律适用 [NATIONAL JUDGES COLLEGE LAW JOURNAL], issue 1, at 6 (2001).

[95] See 程啸 (Cheng Xiao), 主合同无效时保证人的责任问题 [On Guarantee's Liability for Invalid Chief Contract], 法学论坛 [LEGAL FORUM], issue 6, at 99-100, (2005).

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social customs because the damage here is pure economic damage. If using the restitution rule proposed by this article, loan contracts will be handled under the following rule: If the loan contract is invalid due to unlawful behaviors of the parties (not including invalidation based on fraud and coercion), even the guarantee contract is invalid correspondingly, guarantor's remedy of recovering the collateral or exempting from guarantee liability shall be subject to the limitation of article 58, paragraph 1 of the Contract Law. That is to say, the guarantee liability shall not be exempt within the scope of principal repayment unless the guarantee contract is invalid for its subject matter or for fraud and coercion reasons.

C. Desirable Rule of Recovery under Illegal Contract

Regulations on private law is costly not only for the expenses for regulation itself, but some other negative impacts it brings especially the legal consequences of encouraging bad faith. When facing a trade off between achieving the regulatory goal and preventing bad faith, people have a lot of choices. One of those choices is to allow bad faith based on the regulatory requirement and support (or do not support) their claim of restitution. So that people will behave themselves and be afraid of breaching the regulations, thus helping the implementation of such regulations. Therefore, the countries implementing regulation in such area obtain a uniform or standardized effect; while what it damages are the good faith as general social wealth and also the expectation of fair, justice and chronic authority of law. Another choice is to establish a rule to coordinate the relationship between bad faith and regulation. It can help to achieve the regulatory goal and also encourage good faith, thus balancing parties' interests.

This article agrees to reconcile the relationship between regulation and bad faith on the basis of regulating bad faith behaviors. At the legislative level, if we can go one step further, we may consider setting the following rules:

i. When evaluating whether to return the performance or the interests relevant, we shall first consider the legal purpose, including the proportional relationship between the specific contents of the purpose and its means.

ii. In case of serious offence, particularly those crimes penalized by confiscation of property in Criminal Law including sale of

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drugs and firearms smuggling, parties' claim for restitution shall be excluded in addition to invalidate the illegal transaction.

iii. For those crimes not punished in the form of confiscation of property, when the party tries to circumvent though illegal transaction which is not a serious law-breaking offense and even if the law denies the validity of the transaction itself, the party who has fulfilled his obligation shall be allowed to claim for restitution, including the return of necessary proceeds. Only when the offense is serious, we may consider using private meanings to prevent parties' illegal conduct.

iv. In the case where both parties are unlawful and one party is benefiting from the inexperience, mental defects or irresistible conditions of the other party (such as casino lending), the contract then can be confirmed as invalid and the enrichment of the weak party is not required to return.

v. If the strong party circumvents the regulatory norms which have an attribute to protect the weak one, we should allow the weak party to breach the trust and support his claim of invalidating the contract and stopping performance. Taking the regulation on leasing as an example, if the lessor has reached a higher amount of rental in the transaction, we could first consider the strong party as bad faith.

D. Summary

It must be admitted that China has a complex and comprehensive regulation system on invalidation of illegal contract. The first layer is the confirmation of contract invalidation, and the second layer is the system on legal consequence including the interaction between restitution (including the unjust enrichment excluding the non-recovery under illegal enrichment and ownership return) and damage. It is not difficult for the judge to find a suitable instrument from these rules to support his conclusions after the judge has formed his inner conviction. In this sense, the current law is not entirely infeasible if applied properly. But this kind of "proper" usage lacks of internal logic and is guided by the consequentialism thinking, rather than a consistent and fluent dogmatics reasoning. As revealed by a huge number of practical cases, the problem lies in the lack of certainty and inability to provide a strong legal support for the judges' discretion, and thus easily lead

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to misjudgment, causing substantive injustice, and indirectly encouraging the bad faith behavior. If the recovery under illegal contract could be managed under the framework of illegal enrichment, the relationship between the first and second layers' systems as mentioned above will be better clarified because of its consistent core value. It will also integrate the value of good faith, justice and other values into practical discretion to achieve the certainty of law.

VI. Conclusion

This article concentrates on the relationship between regulation and good faith. Through the study on the recovery under illegal contract, this article has formed the following conclusions: First, the restitution rule stipulated in the first sentence of Article 58 of the Chinese Contract Law was too rigid. It has confused the differences between revocation and invalidation, and also between legality and illegality. The legal consequence for illegal contract shall be handled by the rule of illegal enrichment. Second, general principles and exceptions coexist in the system of non-recovery under illegal enrichment. Drawing lessons from this system and its considerations, we can increase the layers of such rule in China, then better respond to the regulatory needs while not extremely change the interests of the parties. The damage for invalid contract was specified in the second sentence of Article 58 of the Contract Law, which could be better explained under the unjust enrichment rule. Third, due to the intersection of contract law and unjust enrichment law, the system of illegal enrichment highlights the conflict between regulation and good faith which is an important social wealth and should be maintained by law. In determining whether the enrichment shall be returned and what is the scope of recovery, two things need to be considered, namely the regulatory purposes on the one hand and the parties' subjective state with the degree of severity of law-breaking on the other hand, in particular the possible bad faith legal consequences.

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Revolutionary Reform in the U.S.: Learning from the American Experience of Constitutional Amendment outside Article V

Stephan JAGGI[*]

I. INTRODUCTION

The European Union's (EU) constitutional law has an amendment problem. The EU Treaties, recognized as establishing EU constitutional law,[1] can, based on Article 48 of the Treaty of the European Union (TEU),[2] only be amended by unanimous decisions of all EU Member States.[3] Whenever EU constitution law shall be amended, Article 48 TEU thus requires the agreement of all twenty eight Member States, which means that every government as well as every parliament of every Member State has the authority to veto the amendment.[4] This obstacle to constitutional change has been experienced as painful, particularly during times of crises, such as the European banking crisis when fundamental change was needed, and was needed fast.

It is in the light of this experience that, for quite a while, people have been thinking about alternative ways of amending EU

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* Stephan JAGGI, previously served as An Associate Professor of Law at the Peking University School of Transnational Law. He holds a German doctoral degree (Dr. iur.) from the University of Freiburg, an LL.M. degree from Yale Law School, and an American doctoral degree (J.S.D.) from Yale Law School. After working as an associate lawyer in Covington & Burling' s Brussels office for two years, he was appointed Judge in Germany in 2001. In 2008 he was appointed Judge at the Court of Appeals of the State of Schleswig-Holstein/Germany.

[1] *See e.g.*, J.H.H. Weiler, *The Transformation of Europe*, 100 YALE L.J. 2403, 2407(1991).

[2] In the form of the Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community (Treaty of Lisbon); the Treaty on European Union retains its name (TEU) (for a consolidated version, see 2008 O.J. (C 115) 3); the Treaty establishing the European Community is renamed Treaty of the Functioning of the European Union (TFEU) (for a consolidated version, see 2008 O.J. (C 115) 47).

[3] *See* DAMIAN CHALMERS ET AL., EUROPEAN UNION LAW: CASES AND MATERIALS 76. (2nd ed. 2011).

[4] Article 48 (6) and (7) of the TEU provide for simplified procedures, which still require unanimity of all member states.

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constitutional law.[5] Member States as well as academic authors have been exploring options of informal constitutional change, such as specific international agreements, broad interpretation of competence norms, and judicial deference to decisions by other branches of the government.[6] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union,[7] for example, is an international treaty establishing rules on fiscal discipline and introducing a specific bailout mechanism which was signed by all European Member States except the United Kingdom and the Czech Republic.[8] The broad interpretation of the Council's and the European Parliament's authority based on Article 114 TFEU[9] to adopt the European Banking Union as a measure to promote the functioning of the internal market is an example for a broad interpretation of a competence norm in combination with judicial deference to the decision made by other branches of the government.[10]

In order to better understand how alternatives to formal constitutional amendments can legitimately be developed, some athors propose to look to the U.S., where Article V of the Constitution establishes comparably demanding requirements for formal constitutional amendments. One proposal wants to take as a role model for an informal way of constitutional amendment the U.S.'s New Deal experience, which is considered as an example for constitutional amendment through the U.S. Supreme Court's deference to the government's political branches, in particular to the legislature.[11] It is argued that, in the light of the U.S.'s New Deal experience, EU constitutional law could similarly be amended by the Court of Justice of the EU (CJEU) deferring to

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[5] *See e.g.*, PAUL CRAIG & GRÁINNE DE BÚRCA, EU LAW: TEXT, CASES, AND MATERIALS 131 (5th ed. 2011); *supra* note 3, at 1.

[6] *See* Andreas Orator, Deconstitutionalization of the EU Treaties? Prospects for and Limits to Remedying a Dysfunctional Mechanism of Constitutional Amendment, 10, 14. (May 15, 2015) (unpublished manuscript) (on file with author).

[7] Also known as the "Fiscal Compact", formally concluded on March 02, 2012 and entered into force on January 01, 2013.

[8] *See* Orator, *supra* note 6, at 15.

[9] For the Treaty on the Functioning of the European Union, see 2008 O.J. (C 115) 47.

[10] *See* Orator, *supra* note 6, at 16.

[11] *See id.*

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the EU's political branches in their attempts to develop solutions to important political and economic problems, such as the EU's recent financial crisis.

My thesis is that U.S. constitutional history does provide important study materials to inform possibilities of informal constitutional change in the EU. The crucial question, however, is what exactly these materials teach. I will argue that the study of informal constitutional change in the U.S. teaches *three important lessons*: (i) Look at all precedents, not only the New Deal; (ii) Don't expect informal constitutional change to be any easier or faster than formal amendment; it will only be different; and (iii) Don't focus on the court but take all players into account.

II. THE FIRST LESSON

Particularly Bruce Ackerman's account of informal constitutional change in the U.S. teaches that *the New Deal is only one example of informal constitutional change*.[12] Other equally important and instructive examples of informal constitutional change in the U.S. are (i) the Foundation, (ii) the First Reconstruction, and (iii) the Second Reconstruction or Civil Rights Revolution.

The Foundation, i.e. the 1787 Constitution's adoption, itself is an example of informal constitutional change brought about outside the existing constitutional order's rules for constitutional amendment. When the Philadelphia Convention drafted a new constitution for the U.S. during the summer of 1787, the constitution in force was the Articles of Confederation adopted by the thirteen sovereign states in 1781. Article XIII of the Articles stated that "the union shall be perpetual" and that no "alteration at any time hereafter be made in any of them; unless such alteration be agreed to in a congress of the united states, and be afterwards confirmed by the legislatures of every state".[13] Despite these

[12] For this and the following, I rely heavily on Bruce Ackerman's *We the People, Volume 1: Foundations* (1991), *We the People, Volume 2: Transformations* (1998), and *We the People, Volume 3: The Civil Rights Revolution* (2014).

[13] MAX FARRAND, THE FRAMING OF THE CONSTITUTION OF THE UNITED STATES 223 (1913).

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clear rules, Article VII of the drafted new Constitution not only dropped the unanimity requirement by being content with the adoption of the new Constitution by nine out of thirteen states but also cut the state legislatures out of the picture by requiring specially elected constitutional conventions to ratify the new constitution. Moreover, the Philadelphia Convention had been authorized by Congress in February 1787 "for the sole and express purpose to revising the Articles of Confederation".[14] By proposing a brand-new Constitution, the convention clearly overstepped its authority. Ackerman calls this "illegalities".[15] Akhil Amar disagrees with Ackerman's verdict. Amar argues that since the Articles of Confederation were a treaty between sovereign states, which had been violated repeatedly on every side, the states were entitled to disregard the Articles, including Article XIII. In light of the fact that James Madison himself calls the changes proposed at Philadelphia "*informal and unauthorized propositions*" and argues that "as the plan to be framed and proposed was to be submitted to the people themselves … its approbation [would] blot out antecedent errors and irregularities",[16] I tend to agree with Ackerman. What is more important, however, is that both scholars and James Madison agree that America's Foundation is an example for constitutional lawmaking by the people as the popular sovereign outside existing provisions of constitutional amendment.[17]

America's First Reconstruction is another case in point, even though its constitutional achievements were finally forged into the 13th, 14th, and 15th Amendments. The 13th Amendment's Article V problem is that the amendment was proclaimed as

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[14] PAUL BREST ET AL., PROCESSES OF CONSTITUTIONAL DECISION-MAKING: CASES AND MATERIALS 21 (5th ed. 2006).

[15] BRUCE ACKERMAN, WE THE PEOPLE, VOLUME 1: FOUNDATIONS 41 (1991).

[16] Federalist No. 40 (Madison), ALEXANDER HAMILTON ET AL., THE FEDERALIST PAPERS 253 (Clinton Rossiter ed., 1961).

[17] *See* Akhil Reed Amar, *Philadelphia Revisited: Amending the Constitution Outside Article V*, 55 U. CHI. L. REV. 1043, 1047–48 (1988) (Amar pointing out that he disagrees with Ackerman about the latter's conclusion that the ratification of the 1787 Constitution was "plainly illegal" but that he agrees with Ackerman's "more basic conclusion that our Constitution may be popularly amended in ways other than those explicitly set forth in Article V); Akhil Reed Amar, *The Consent of the Governed: Constitutional Amendment Outside Article V*, 94 COLUM. L. REV. 457, 490–500 (1994).

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ratified by three-fourth of the states, eight of whom were states of the former Confederacy, despite the fact that two weeks earlier, on December 4, 1865, the Thirty-ninth Congress had declared that these very eight states had "no legal state governments" and had refused to seat House members and senators from these states.[18] How could the 13th Amendment be ratified under Article V by states that did not have a legal state government?[19]

The 14th Amendment poses similar problems. The two-thirds majority in both Houses of Congress required by Article V to propose the 14th Amendment could only be mustered by excluding the Southern senators and representatives from Congress in June of 1866.[20] The representatives of ten Southern states were only allowed to take their seats in Congress after their states had ratified the 14th Amendment and the 14th Amendment had become part of the Constitution.[21] How could the Southern states be excluded from Congress for purposes of proposing the 14th Amendment but at the same time be counted as proper legislatures for purposes of adopting the 14th Amendment? On top of all this, it was very clear that the Southern states had been coerced into adopting the 14th Amendment. Ackerman calls this "naked violations of Article Five" and argues that the 14th Amendment's ratification "can be nothing less than a revolutionary act".[22] Even though Amar finds a way to place the 13th and 14th Amendments "within the general Article V framework", he admits that Reconstruction Republicans "repeatedly found themselves obliged to improvise … to resolve many difficult legal issues.[23] Amar argues that the Thirty-ninth Congress legitimately excluded Southern representatives and senators from being seated because by excluding free black people from the vote after 1865 their states had violated Article VI Sec. 4's "Republican Form of Government" requirement.[24] Again, both scholars agree that

[18] *See* BRUCE ACKERMAN, WE THE PEOPLE, VOLUME 2: TRANSFORMATIONS 101 (1998) (citing the Reconstruction Act, ch. 153, § 5, 14 Stat. 428–429 (1867)). *See also* AKHIL AMAR, AMERICA'S CONSTITUTION: A BIOGRAPHY, 364–65 (2005).

[19] *See* ACKERMAN, *supra* note 18, at 102.

[20] *Id.*

[21] *Id.* at 110, 111.

[22] *Id.* at 111.

[23] *See* AMAR, *supra* note 18, at 366.

[24] *Id.* at 368, 372.

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exceptional measures deviating from the traditional Article V procedure had been taken in order to amend the constitution during America's First Reconstruction.

The New Deal and the Civil Rights Revolution did not even pretend to follow Article V in their quest for constitutional change. And this, of course, is where the controversy starts. Is it possible to make constitutional law not just outside Article V but without changing the constitution's text at all? "Of course", Ackerman responds emphatically; Founders and Reconstruction Republicans have demonstrated how existing amendment provisions can be ignored (Foundation) and national institutions can force reluctant states to accept that the American people have spoken in a constitutional voice (Reconstruction).[25] Still, constitutional amendment without any change in the constitution's text at all is new and requires explanation. Ackerman's answer is that the "transformative opinions handed down by the New Deal Court function as *amendment-analogues* that anchor constitutional meanings in the same symbolically potent way achieved by Article Five amendments."[26] *Marbury v. Madison*, for example, is also considered constitutional law even though judicial review is not in the text of the written constitution so that, theoretically, a simple majority in Congress, un-vetoed by the president, could "reverse *Marbury v. Madison* and decisively undermine the current practice of judicial review."[27] "Yet this formal point does not deprive *Marbury* of a canonical place in our tradition."[28] Written constitutional law is not just the "*amendment simulacra* generated by the Republicans under the nationalistic procedures developed during the Reconstruction" but also "the transformative opinions that serve as *amendment-analogues* under the nationalistic procedures developed by the Democrats during the Great Depression."[29] Ackerman argues that the New Deal Democrats only followed the Reconstruction Republicans' precedent in developing ways outside Article V in order to express the

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[25] *See* ACKERMAN, *supra* note 18, at 269.

[26] *Id.* at 269, 270.

[27] BRUCE ACKERMAN, WE THE PEOPLE, VOLUME 3: THE CIVIL RIGHTS REVOLUTION 81, 82 (2014).

[28] *Id.* at 82.

[29] ACKERMAN, *supra* note 18, at 270.

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constitutional will of the American people.[30] Based on this theory of informal constitutional change, according to Ackerman, Franklin Roosevelt and the Democrats in Congress changed American constitutional law through landslide electoral victories in 1936, 1938, etc., the adoption of landmark statutes such as the National Labor Relations Act and the Social Security Act, and the handing down of superprecedents such as *Wickard v. Filburn* and *United States v. Darby*.[31]

The Civil Rights Revolution, in turn, followed the New Deal precedent in finding new ways to speak with a constitutional voice in the name of We the People through a combination of electoral victories, landmark legislation, and super precedents.[32] Lyndon Johnson's landslide victory in 1964, Congress' adoption of Civil Rights Act of 1964, the Voting Rights Act of 1965, and the Fair Housing Act of 1968, and the Supreme Court's super-precedents, such as *Brown v. Board of Education*, *Heart of Atlanta Motel v. United States*, and *Katzenbach v. McClung* combine to formulate the constitutional principles of the Civil Right Revolution. Ackerman argues Lincoln would have followed the same route if he had lived to try[33] and constitutional law may be even better and more clearly elaborated if the elaboration is undertaken in landmark statutes and super-precedents instead of "cryptic" constitutional text.[34]

Accordingly, the New Deal as well as the Civil Rights Revolution are fundamentally similar to earlier acts of popular sovereignty, such as the Foundation and the Reconstruction in making constitutional law outside existing amendment provisions. Doctrinally, Ackerman's bases his case on *Coleman v. Miller*, which he reads as the U.S. Supreme Court declaring the question of whether or not the Article V requirements are fulfilled a non-justiciable political question.[35] Ackerman reads *Coleman* as the Court's declaration that "the time had come for lawyers to

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30 *Id.* at 273.
31 *See id.* at 279; ACKERMAN, *supra* note 27, at 40.
32 *See* ACKERMAN, *supra* note 27, at 5, 63.
33 ACKERMAN, *supra* note 18, at 274, 275.
34 *Id.* at 276.
35 *See Id.* at 261–66; Coleman v. Miller, 307 U.S. 433, 450 (1939).

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confront the fact that our higher lawmaking tradition could not be cabined within a neat legalistic understanding of Article Five."[36]

Despite his emphasis on popular sovereignty, the only elements of constitutional relevance that Amar is willing to see with respect to the New Deal is the 22nd Amendment, adopted in 1951, limiting the president to two terms in office. The only events of constitutional relevance during the Civil Rights Revolution are, from Amar's perspective, the 23rd Amendment giving citizens residing in the District of Columbia a vote in presidential elections, the 24th Amendment abolishing the poll tax but only for federal elections, the 25th Amendment regulating the succession of the president and the vice president, and the 26th Amendment reducing the minimum voting age from twenty-one to eighteen.[37] These amendments do not reflect the major constitutional changes brought about by the New Deal and the Civil Rights Revolution as Ackerman describes them in his detailed accounts of the events.

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[36] ACKERMAN, *supra* note 18, at 264. In my opinion, Ackerman's interpretation of *Coleman v. Miller* goes a little far. Chief Justice Hughes, writing for the Court, only says that "the question of the efficacy of ratifications by state legislatures, in the light of previous rejection or attempted withdrawal, should be regarded as a political question pertaining to the political departments, with the ultimate authority in the Congress in the exercise of its control over the promulgation of the adoption of the amendment." *See Coleman*, 307 U.S., at 450. And further "we think that the Congress in controlling the promulgation of the adoption of a constitutional amendment has the final determination of the question whether by lapse of time its proposal of the amendment had lost its vitality prior to the required ratifications." *See Coleman*, 307 U.S., at 456. It is only the concurring opinion by Justice Black, joined by Justices Roberts, Frankfurter, and Douglas that formulates a broader principle: "undivided control of that process [the Article V amendment process] has been given by the Article exclusively and completely to Congress. The process itself is political in its entirety, from submission until an amendment becomes part of the Constitution, and is not subject to judicial guidance, control or interference at any point." *See* Coleman, 307 U.S., at 459. Still, even the broadest reading of *Coleman* seems to leave us with a minimum formal requirement for constitutional amendment established by Article V: a determination by Congress that the constitution has been amended. Such determination, it may be argued, is missing with respect to both, the New Deal and the Civil Rights Revolution. For a more limited view of Coleman, see LAWRENCE TRIBE, AMERICAN CONSTITUTIONAL LAW, VOL. ONE, 371–72 (3rd ed. 2000).

[37] *See* AMAR, *supra* note 18, at 433–38, 440, 457, 475.

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Therefore, if we want to understand informal constitutional change in the U.S. we should consider all the precedents, not only the New Deal.

III. THE SECOND LESSON

Informal means of constitutional lawmaking were not developed because they were easier or faster than the formal amendment procedures but because they were responses to fundamental changes in the character of the American Republic. One of these changes was from a states-based to a nation-based republic and is a common feature of the Foundation, Reconstruction, New Deal, and Civil Rights Revolution.[38] The break with the Articles of Confederation and the adoption of new rules under the 1787 Constitution, for example, were not undertaken because Art. VII and Art. V of the 1787 Constitution would make it easier to amend constitutional law but because the nature of the republic had changed from a confederation of sovereign states to a nation whose practical problems required a much stronger federal government. Adopting the new Constitution under its Art. VII rules was still an onerous task that, even though it did not require a unanimous vote by the legislatures of all member states, still required an arduous process of public debate through which the people and ratifying conventions in nine states had to be convinced.[39]

The informal ways of changing the constitution during the Reconstruction, the New Deal, and the Civil Rights Revolution, too, were responses to the fact that Article V had been created for a state-centered republic that had changed its political identity to a nation-centered republic.[40] People were no longer thinking of themselves primarily as Georgians or New Yorkers, but as Americans.[41] Moreover, they were increasingly confronted with problems that could no longer be solved through state-centered action but required strong federal measures. The way there was neither easy nor fast.

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[38] *See* ACKERMAN, *supra* note 18, at 13.
[39] *See id.* at 5.
[40] *See* ACKERMAN, *supra* note 27, at 28.
[41] *Id.*

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Reconstruction Republicans, for example, knew that Article V would have given ten out of eleven states of the former Confederacy an absolute veto power over the 14th Amendment. This is why Reconstruction Republicans decided to not play by the Article V rules.[42] However, their informal way of winning the authority to adopt the 14th Amendment in the name of the People was long and hard. Not only did it take a Civil War to adopt the Reconstruction Amendments, but it required also a tedious struggle between the president and the Congress. The adoption of the 14th Amendment started with an impasse between President Andrew Johnson opposing the 14th Amendment and the Republican Congress trying to adopt it.[43] The Republicans used a decisive victory in the Congressional elections of 1866 in order to claim a popular mandate for the 14th Amendment.[44] President Johnson denied such a mandate and encouraged ten Southern states to veto the 14th Amendment under Article V. Congress reacted by enacting the Reconstruction Act of March 2, 1867 and impeached President Johnson in 1868. The 14th Amendment thus became the hot-button issue of the 1868 elections. Johnson decided to change his position on the 14th Amendment in order to preserve his presidency, and the 1868 elections consolidated this "switch in time"[45] by bringing Ulysses Grant into the White House and confirmed the Republican's firm control of Congress. An epic struggle, indeed.

The New Deal and the Civil Rights Revolution required equally complicated and long-term struggles of the branches of government before they were able to change constitutional law in the name of We the People. The change from a "Federalist model of constitutional change", characterized by the division of powers between states and nation and requiring a cooperation of federal and state governments for constitutional amendment, to a "Re-

[42] With 37 states in the Union during the 1860s, any ten states had an absolute veto power over constitutional amendments under Article V. Eleven states had been members of the former Confederacy and not all Northern states were reliable supporters of the 14th Amendment. *See* ACKERMAN, *supra* note 18, at 16.

[43] For a brief overview of the five-stage process of the "unconventional" adoption of the 14th Amendment, see *id.*at 18–21.

[44] For this and the following, see *id.* at 19.

[45] *Id.* at 20.

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publican model of constitutional change", characterized by the separation of powers between Congress, President, and Court in combination with the "staggered" terms in office for Representatives (two years), the President (four years), Senators (six years) and the Court (life tenure) makes it difficult for a political movement to bring about constitutional change.[46] Referring to the New Deal and the Civil Rights Revolution, Ackerman writes that a political movement "must take an arduous march through the presidency, Congress, and the Court before it can legitimately enact sweeping changes"; he emphasizes that "many have tried and few have succeeded in sustaining popular support over this formidable obstacle course."[47]

Informal constitutional change outside Article V has thus been neither easier nor faster, only different.

IV. THE THIRD LESSON

It is not the court alone that brings about informal constitutional change by deferring to political institutions.[48] To the contrary, Ackerman explicitly complains about "[t]he dominant professional narrative" being "court-centered".[49] Based on Ackerman's account of informal constitutional change in the U.S., the court is only one player in a complex interaction between movement, party, president, Congress, court and the people. For example, what Ackerman calls the "signaling", i.e. an institution's assertion that fundamental change is needed, is enacted by different institutions at different times.[50] The First Reconstruction saw the Congress signaling the need for fundamental change by refusing to seat the Southern representatives and senators that were opposing the 14th Amendment.[51] During the New Deal, it

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[46] *See id.* at 20, 21; ACKERMAN, *supra* note 27, at 43. For a more detailed overview regarding the New Deal, see *id.* at 23; regarding the Civil Rights Revolution, see ACKERMAN, *supra* note 27, at 48.

[47] ACKERMAN, *supra* note 27, at 43.

[48] For a similar conclusion with respect to the EU's constitution, see WEILER, *supra* note 1.

[49] ACKERMAN, *supra* note 27, at 2.

[50] For this and the following, see *id.* at 44–47.

[51] For a detailed account, see *supra* note 18, at 166–173.

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was the president with his signing into law of the National Industrial Recovery Act.[52] And, finally, during the Civil Rights Revolution, it was the Warren Court with *Brown v. Board of Education*.[53] The signaling of fundamental constitutional change usually puts the signaling institution into a conflict with other institutions who do not want to take on the proposal for change. This is where elections come in and either stop the movement for change or move it to the next stage, the so-called "proposal phase".[54] In that phase "the House, Senate, and president are finally prepared to pass landmark statutes that break sharply with the constitutional status quo", which makes it clear to the people of the United States that fundamental change is taking place.[55] This gives people in the next elections the chance to say whether or not they like what they see. If they vote against the party/candidate of change, the movement is over. If, however, they provide it with a sweeping victory, Ackerman calls that the "triggering election" which gives the winner the chance to claim a mandate from the people and intensify the course for constitutional change.[56] This brings the process to the fourth stage, the stage of "mobilized elaboration". Here, the movement is in control of all key institutions, which allows it to produce "a stream of landmark statutes, judicial super precedents, and (perhaps) formal amendments that transform its mandate from the people into an enduring constitutional legacy".[57] The next presidential election is then, possibly, a "ratifying election". That means that, when the party for constitutional change wins again, that victory "generates a collective sense that the old regime is a thing of the past".[58] During the following "consolidating phase", the challenge is no longer to defend the constitutional change against its opponents but instead to "refine the terms of the new constitutional consensus in a

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[52] *Id.* at 281, 286.

[53] *See* ACKERMAN, *supra* note 27, at 51.

[54] *Id.* at 45.

[55] *Id.*

[56] *Id.*

[57] *Id.* at 46.

[58] *Id.*

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further series of statutes, executive initiatives, and judicial decisions".[59] Finally, the system returns to "normal politics".[60]

In the light of this complex process, it would be misunderstanding the New Deal to consider it an example for constitutional lawmaking by a Supreme Court deferring to the president and Congress. To the contrary, after the Roosevelt administration had enacted the NIRA less than four months after Roosevelt's inauguration,[61] the Court acted as a road block in *Schechter Poultry v. U.S.* (1935) and prevented the desired fundamental changes. The Court only changed its mind after repeated electoral victories in presidential and congressional elections had signaled overwhelming popular support for the New Deal measures. But even then it was "[o]nly Roosevelt's precedent shattering third term [that enabled] him to reconstitute the entire Supreme Court, which then unanimously endorsed the principles of New Deal constitutionalism in ringing terms".[62] Ackerman's account of the New Deal demonstrates that it took much more than a deferential court to bring about informal constitutional change during the New Deal.

It was only during the Civil Rights Revolution that the Court acted as the signaling institution. And even here the Warren Court's decision in *Brown v. Board of Education* (1954) was only a first step in a multi-institutional process of informal constitutional change in which "[i]t was only when President Lyndon Johnson and his liberal Congress followed through with a series of landmark statutes [Civil Rights Act of 1964, Voting Rights Act of 1965, and Fair Housing Act of 1968] that *Brown's* promise became a fundamental premise of the modern republic".[63] It still required Richard Nixon's unwavering support of the landmark statutes to turn his election in 1968 into an event that "ratified" the constitutional change and to turn his presidency into a phase that consolidated that change.[64]

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[59] *Id.*
[60] *Id.*
[61] ACKERMAN, *supra* note 18, at 286.
[62] *Id.* at 5.
[63] *Id.*
[64] ACKERMAN, *supra* note 27, at 77, 78, 218.

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In order to understand informal constitutional change in the U.S., we should thus not only look at the court but at all the players.

V. CONCLUSION

What does all of that mean for informal constitutional change in the EU?

The first insight, I think, is that since the process of informal constitutional change in the U.S. has been strongly determined by very specific historical, political, economic, and legal circumstances, informal constitutional change in the EU is probably going to be similarly specific. One should therefore be very careful with applying American concepts to the EU. The challenge will be to closely observe and analyze the specific processes of informal constitutional change in the EU in order to detect their specific character and, based on that, develop a specific EU concept of informal constitutional change.

The second insight is that, if there is informal constitutional change in the EU, a challenge will be to determine its exact content. As Ackerman's and Amar's work shows, it is one thing to find out how constitutional law is being or can be changed outside Article V; it is quite another thing to determine the exact content of that change. A conceivable advantage of Article V-based change is that we can look at the amended constitutional text and read it. To elaborate new constitutional principles out of a multitude of electoral victories, landmark statutes, and super precedents may be more challenging.

The third insight points to the importance of the question of legitimacy. The decisive legitimating criterion uniting all events of informal constitutional change in the U.S. is popular sovereignty. Ackerman's and Amar's common message is that the American people as the sovereign are not bound by Article V when speaking in their constitutional voice. What government institutions are doing at times of informal constitutional change is developing alternative ways to speak in the name of We the People. Against that background, the big question that EU institutions involved in informal constitutional change are facing is:

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who is the sovereign in whose constitutional voice we need to speak in order to make informal change legitimate? In the EU, where people still think of themselves more as Germans or Italians than as Europeans, that question seems to be answered by Art. 48 TEU, according to which the Member States are the sovereigns so that every Member State has a veto on constitutional amendments. How seriously Member States are taking their sovereignty has been demonstrated, for example, by the German Federal Constitutional Court in a 2009 decision on the Lisbon Treaty.[65] The Court decided that where general or specific bridging clauses allow the European Council to authorize the Council to act by a qualified majority instead of by unanimity, the national parliament's right to make known its opposition (as provided for by Article 48.7(3) TEU) is not enough; authorization through a formal law by the German legislature is always required.[66]

Against that background, one way of amending the Treaties outside of Art. 48 TEU would be for Member States to leave the EU and get together on the basis of a new treaty with a different provision for constitutional amendment. Article 50 of the Lisbon Treaty explicitly introduces a right for each Member State to withdraw from the EU. Another way would be to exchange the sovereign and replace the Member States with the people of the EU. In that case too, however, the EU institutions would have to develop ways to engage the new sovereign in political discourse of an intensity that would allow the institutions to speak in the name of We the People of the EU. Whichever way the EU choses, the U.S. experience shows that there is no higher lawmaking without the sovereign. That means that constitutional change, whether formal or informal, will remain complex, time consuming, and arduous, as it should.

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[65] BverfG, Jun. 30, 2009, docket number 2 BvE 2/08 (Ger.), *available at* Bundesverfassungsgericht.

[66] *Id.* at para. 319–321.

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Protection of Preferred Shareholders Under China's New Rule

*ZHONG Xiaozhu**

ABSTRACT

A horizontal conflict exists when managers attempt to maximize shareholder's wealth by transferring benefits from preferred shareholders to common shareholders. Preferred shareholders urgently need meaningful protection.

On March 21, 2014, China enacted a new administrative rule Pilot Measures for the Administration of Preferred Stock (the "Measures"), which legally allows the preferred stocks to be issued in China's stocks market. The protection of preferred shareholders is an important and disputed issue, especially in current China.

This article reviews the developments of China's preferred stock market, analyzes potential risks of preferred shareholders, introduces the methods of preferred shareholder protection in the U.S. and in the Measures, and finally proposes that imposition of mandatory fiduciary duty by contract, building a special committee, and divided board control are great ways to mitigate the horizontal conflicts between common and preferred shareholders in current China.

Key words: *Preferred Stock, Shareholder Protection, Horizontal Conflicts*

* ZHONG Xiaozhu, J.D. & J.M., Peking University School of Transnational Law, class of 2016, currently working as an associate in Zhong Lun Law Firm Shanghai Office.

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I. INTRODUCTION

Preferred stock is a critical source of capital for corporations and is also an essential part of modern finance, for it can provide incomparable financing flexibility.[1] During 1999 to 2005, U.S. firms have issued preferred stock over USD $868 billion, while only $374 billion were raised through Initial Public Offerings ("IPOs").[2] The main characteristic of preferred stock is the separation of voting rights and cash flow rights, which enables unsophisticated investors to receive fixed dividends without worrying about the fluctuation of stock price.[3] Furthermore, during the liquidation of a corporation, preferred shareholders will get paid before common stockholders and after bondholders.[4] In spite of great advantages of preferred stock, it has almost disappeared in certain industries in the U.S. nowadays, as it is hard for preferred shareholders to enjoy sufficient legal protection.[5]

Despite the fact that preferred stock used to be widely applied in western countries to provide investors with fundamental economic rights such as anti-dilution adjustments, liquidation preferences, etc.,[6] legislative limitations in China did not offer clear guidance and the past practice was in disorder.[7] Transaction parties took risks in realizing the functions of preferred shares; meanwhile, courts refused to recognize the legality of these measures. Luckily, China's new administrative rule emerged as a turning point. For the purposes of providing direct financing tools, adjusting companies' finance structures, and encouraging mergers

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[1] *See* Ben Walther, *The Peril and Promise of Preferred Stock*, 39 DEL. J. CORP. L. 161, 173 (2014).

[2] *See* Jarl Kallberg, Crocker H. Liu & Sriram Villupuram, *Preferred Stock: Some Insights into Capital Structure*, 21 J. OF CORP. FIN. 77, 77 (2013).

[3] *See* Jing Li, *Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations*, 1 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 1, 24 (2012).

[4] *See* Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care about It)*, 51 BUS. L. 443, 445–46 (1996).

[5] *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 892 (2002).

[6] *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 284 (2003).

[7] *See infra* Part II. D.

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and acquisitions,[8] on March 21, 2014, the China Securities Regulatory Commission ("CSRC") enacted the Pilot Measures for the Administration of Preferred Stock (the "Measures"). This legal document is the very first specific administrative rule[9] about preferred stocks mechanism and is a turn away from China's prior conservative approach to preferred stock.

Minority shareholders are usually not well protected from expropriations by majority shareholders.[10] Preferred shareholders, who usually belong to minority shareholders, are in more vulnerable positions[11] because they generally do not enjoy voting rights.[12] A horizontal conflict[13] will be created between preferred and common shareholders because the two groups hold different interests—common shareholders are paid dividends depending on the profits of the company and favor riskier decisions, while preferred shareholders realize gains from fixed dividends and prefer safer ways.[14] Directors usually would favor

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[8] *See* 国务院关于开展优先股试点的指导意见 [Guidelines of the State Council on Launch of Preference Shares Pilot Scheme] (promulgated by the St. Council, Nov. 30, 2013, effective Nov. 30, 2013) CLI.2.213719 CHINALAWINFO.

[9] Levels of China's laws are divided into four tiers from the highest to lowest: constitution, laws, administrative regulations, department rules/local regulations/local rules. Constitution is the highest while laws are higher than administrative regulations which are higher than the others. The department rules and local rules are equally effect while local regulations are higher than local rules. *See* 立法法(2015 修订) [Law on Legislation (2015 Amendment)] (promulgated by Nat'l People's Cong. Mar. 15, 2015, effective Mar. 15, 2015) arts. 87–89, 91, 95, CLI.1.245693 CHINALAWINFO.

[10] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J.FIN. 471, 486 (1999). *See also* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1644 (2006).

[11] Some scholars argue that this condition is not unfair for preferred shareholders are paid in a stable and preferable position and that's the price. This is taught by Professor Sang Yop Kang in his East Asia Economy Structure class. However, this paper still attaches great importance to the protection of preferred shareholders from the view of China's current conditions. *See also* Leo E. Strine, Jr., *Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025, 2027–29 (2013).

[12] *See* Richard M. Buxbaum, *Preferred Stock: Law and Draftsmanship*, 42 CALIF. L. REV. 243, 243 (1954). *See also* Mitchell, *supra* note 4, 473 n.157.

[13] "Horizontal conflict" means that the battle over limited corporate assets and ways of distribution between two groups. *See* Lawrence E. Mitchell, *Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1213 (1990).

[14] *See* Mitchell, *supra* note 4, 445–46.

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common shareholders as the they are elected by the latter group.[15] Therefore, without control power, there is a significant risk that preferred shareholders will not get fair and maximum dividends from a corporation.[16]

What potential risks preferred shareholders may be involved in? Are preferred shareholders worthy of special protection and if so, why? How to protect them, through mandatory law or through contract, or other ways? What kind of protection has the new rule provided for preferred shareholders? What is the ideal model to offer protection to preferred shareholders in China?

China's new rule in general has stipulated four main ways to protect preferred shareholders: total amount restriction, voting rights on vital issues, resuming voting rights on exceptional occasions, and redemption rights,[17] all of which belong to structural rules concerning the allocation of decision-making power and the conditions to exercise such power.[18] Concerning the preferred shareholders protection in the U.S., the U.S. rule imposes mandatory fiduciary duties on rights shared with common shareholders and relies on the contract to bargain the preferential rights.[19] However, under the presumption of business judgment rule,[20] directors usually will not be liable, even if they have made biased decisions adverse to preferred shareholders.[21] Besides, the

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[15] *See* Noelle M. Holladay, *The Limited Fiduciary Duties Owed by Corporate Managers to Preferred Shareholders: A Need for Change*, 88 KY. L.J. 87, 102 (2000).

[16] *See* 朱慈蕴 (Zhu Ciyun), 沈朝晖 (Shen Zhaohui), 类别股与中国公司法的演进 [*Classified Shares and the Evolution of Chinese Corporate Law*], 中国社会科学 [SOCIAL SCIENCES IN CHINA], issue 9, at 155 (2013).

[17] 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] (promulgated by the China Sec. Regulatory Comm'n, Mar. 21, 2014, effective Mar. 21, 2014) arts. 10, 11, 13, 23, CLI.4.221521 CHINALAWINFO.

[18] *See* Melvin Aron Eisenber, *Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989).

[19] *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).

[20] A court "will not substitute its own notions of what is or is not sound business judgment" if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

[21] *See* Holladay, *supra* note 15, at 102. *See also* Robinson v. T.I.M.E.-DC, Inc., 566 F. Supp. 1077, 1084 (N.D. Tex. 1983).

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contractual rights of preferred shareholders may be interpreted very narrowly[22] and even be trumped by fiduciary rights owned by common shareholders.[23]

This article argues that protection of preferred shareholders is highly vital to corporate governance while the current protection in China is insufficient and the U.S. application is unsatisfactory. If no change is made to current legal framework, a comprehensive model is suggested to protect the preferred shareholders—to incorporate a covenant of fiduciary duty in preferred stock contract to make the company more attractive to investors; or to get the preferred shareholders more involved in the decision-making process, through building a special committee for preferred shareholders or establishing a divided board control. In addition, if the current legal framework can be amended, lifting the authority of the rules on preferred stocks to the level of national law is strongly recommended, and the imposition of mandatory fiduciary duties needs to be included in the written law. Furthermore, the law needs to empower the charter to change distributional rules to enabling rules.

Part II reviews the history and current practice of China's preferred stock market and the necessity of building a preferred stock system in China. Part III and IV form the analytical core of the article. Part III points out the expropriation of preferred shareholders and the horizontal conflicts between the preferred and common shareholders. Part IV firstly demonstrates the significance of the preferred shareholder protection; secondly, it introduces the protection of preferred shareholders under China's new rule and in the U.S.; thirdly, Part IV proposes proper models to protect preferred shareholders in China. At last, Part V concludes by summarizing the key points.

II. DEVELOPMENTS OF CHINA'S PREFERRED STOCK MARKET

A. Preferred Stocks and Its Development in China

Preferred stock is a hybrid combing some features of stock and some of bond. Bondholders are traditionally viewed as out-

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[22] *See* Mitchell, *supra* note 4, at 448–49.

[23] *See* Melissa M. McEllin, *Rethinking Jedwab: A Revised Approach to Preferred Shareholder Rights*, 2010 COLUM. BUS. L. REV. 895, 917–19 (2010).

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siders of the corporation and their rights and obligations are bargained in contract;[24] while stockholders are typically regarded as corporate owners, with rights protected by fiduciary duties.[25] Due to preferred stock's mixture character, the legal treatment of preferred stockholders has long been disputed.[26]

Like bondholders, preferred shareholders would be paid a fixed return and enjoy the liquidation preference before common shareholders.[27] Further, preferred stockholders seldom have the ability to vote in board elections, except under certain circumstances when their critical rights are deprived[28] The part that preferred shareholders resemble common shareholders, unlike creditors, is that they cannot sue for breach of contract when their rights are infringed on.[29] The central benefit of preferred stock is the separation of voting rights and cash flow rights, which enables ordinary investors to have stable dividends without worrying about the fluctuation of stock price and enables venture capitalists ("VC") to enjoy control rights even without majority equity ownership.[30] Banks and other similar financial institutions are main issuers of preferred stocks, for banks are regulated to ensure certain level of capital adequacy and preferred stock is an important source of tier-1 capital.[31]

Preferred stocks once existed in several separated rules in 1990s. A local government rule Shenzhen Interim Provisions on the Companies Limited by Shares in February 1992 became the very first legal document mentioning preferred stocks in China.[32]

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[24] *See* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1819 (2013).

[25] *See id*.

[26] *See id*. at 1820.

[27] *See* Mitchell, *supra* note 4, at 445–46.

[28] *See* Buxbaum, *supra* note 12, at 243. Except several important circumstances, such as issuing new preferred stocks, amending corporation charter about preferred stocks and so on. *See also* 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] art. 11.

[29] *See* Walther, *supra* note 1, at 167–73.

[30] *See* Li, *supra* note 3, at 24.

[31] *See, e.g.*, Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 649–56 (2012) (explaining bank capital requirements); STANDARD & POOR'S, PREFERRED STOCK PRIMER (2009), *available at* http://us.spindices.com/documents/research/Preferred_Stock_ Primer_2009.pdf.; LATHAM & WATKINS LLP, Understanding Basel III, (May 20, 2017), *available at* https://www.lw.com/presentations/understanding-basel-III-2014 (noncumulative perpetual preferred stock belongs to tier 1 capital).

[32] *See* 深圳市股份有限公司暂行规定 [Provisional Regulations of Shenzhen

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It has established a basic framework of preferred stocks: the preferential dividend rights, liquidation rights, resuming voting rights, redemption rights and so on.[33] Later, this local government rule was transferred into a local regulation by Shenzhen People's Congress Standing Committee in 1993.[34] In addition, an administrative rule, The Opinions on Standards for the Companies Limited by Shares[35] enacted in May 1992 also empowered corporations to issue preferred stocks. In the commercial practice, Shenzhen Development Bank Ltd., Shenzhen Vanke Co., Ltd.,[36] Hangzhou Tianmushan Pharmaceutical Co., Ltd., and Shenyang Jinbei Co., Ltd. have issued preferred stocks in the 1990s but all of them transferred the preferred stocks into common ones later.[37]

With the development of Company Law of the People's Republic of China in December 1993 ("1994 Company Law"), the preferred stocks system completely disappeared,[38] for the 1994 Company Law only stipulated the common stocks system emphasizing one share one vote and one share one dividend.[39]

Municipality Concerning Joint Stock Limited Companies] (promulgated by Shenzhen Mun. People's Gov., Feb. 19, 1992, effective Feb. 19, 1992), *available at* http://law.wkinfo.com.cn/legislation/detail/MTAxMDAwMTQ1Mjlk?q=深圳市股份有限公司暂行规定.

[33] *See id.* art. 51.

[34] *See* 深圳经济特区股份有限公司条例 [Rules of Shenzhen Special Economic Zone on Companies Limited by Shares] (promulgated by the Shenzhen Mun. People's Cong., Jun. 25, 2004, repealed Nov. 28, 2006) CLI.10.60618 CHINALAWINFO.

[35] *See* 国家经济体制改革委员会《股份有限公司规范意见》 [Opinions on Standards for the Companies Limited by Shares] (promulgated by State Comm'n for Restructuring the Econ. Sys., May 15, 1992, repealed May 30, 2015) art. 23, CLI.4.5738 CHINALAWINFO.

[36] *See* 曹立 (CAO LI), 权利的平衡——优先股与公司制度创新 [THE BALANCE OF RIGHT: PREFERRED SHARES AND CORPORATE SYSTEM INNOVATION], at 150 (2014).

[37] *See* 任尔昕 (Ren Erxin), 关于我国设置公司种类股的思考 [*Thoughts About Establishing the Classified Stocks in China*], 中国法学 [CHINA LEGAL SCIENCE], issue 6, at 101 (2010).

[38] The administrative rules and regional rules including preferred stocks system were repealed because the level of these rules is lower than the national law. Any contradictory part will be invalid. *See* 立法法(2015 修订) [Law on Legislation (2015 Amendment)] arts. 88, 96. ("The effect of laws shall be higher than that of administrative regulations, local regulations, and rules.") ("Where any law, administrative regulation, local regulation, autonomous regulation, separate regulation, or rule falls under any of the following circumstances, the relevant authority shall modify or revoke it (ii) A lower level law contravenes a higher level law....")

[39] 公司法(1994) [Company Law (1994)] (promulgated by the Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994, revised Dec. 25, 1999) art. 130,

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In 2005, a major amendment to China's company law was conducted ("2005 Company Law"). It was this amendment that left some room for preferred stocks. According to Article 127 of 2005 Company Law (as Article 126 of the latest 2013 Company Law), same stocks must bear same rights.[40] Instead of stipulating all stocks must bear same rights, Article 127 implies that different stocks could bear different rights.[41] Unlike the 1994 Company Law that only stipulates one kind of stock, the 2005 revision implicitly allowed different kinds of stocks and also granted the corporation with more power on the allocation of dividends in the charter.[42] Furthermore, Article 132, verbatim as Article 131 of the latest 2013 Company Law, empowers the State Council to make regulations about issuing other kinds of stocks other than those prescribed in the Company Law. This was the first time that the law openly supported classified share system. Guided by this stipulation, Interim Measures for the Administration of Startup Investment Enterprises ("Startup Interim Measures") provided an application for preferred shares in start-up enterprises,[43] and the Twelfth Five-Year Guideline of finance industry has pointed out that a preferred stock system should be established through exploration.[44] However, as the guideline didn't provide any specific details and Startup Interim Measures was only applicable to

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CLI.1.24091 CHINALAWINFO. (This is the earliest version of China's Company Law that has been repeatedly revised in 1999, 2004, 2005, and 2013.)

[40] 公司法(2005 修订) [Company Law (2005)] (promulgated by the Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, revised Dec. 28, 2013) art. 127, CLI.1.60597 CHINALAWINFO.

[41] *See* 任尔昕 (Ren Erxin), *supra* note 37, at 106.

[42] 公司法(2005 修订) [Company Law (2005)] art. 167.

[43] 创业投资企业管理暂行办法 [Interim Measures for the Administration of Startup Investment Enterprises] (promulgated by the Nat'l Dev. and Reform Commission, Ministry of Sci. and Tech., Ministry of Fin., Ministry of Com., People's Bank of China, St. Admin. of Tax'n, St. Admin. for Industry and Com., China Banking Reg. Commission, China Sec. Reg. Commission and St. Admin. of Foreign Exchange, effective Mar. 1, 2006) art. 15, CLI.4.60864 CHINALAWINFO. ("A startup investment enterprise may, by signing an investment agreement with the investment enterprise it invests in, make investments in the unlisted enterprise by way of its stock rights, preferred stocks, convertible preferred stocks and other quasi stock rights.")

[44] 金融业发展和改革"十二五"规划 [Development and Reform of Finance Industry: The Twelfth Five-Year Guideline] (promulgated by People's Bank of China, China Banking Reg. Commission, China Securities Reg. Commission, China Ins. Regulatory Commission and St. Admin. of Foreign Exchange, Sept. 17, 2012, valid from 2011 to 2015) ch. 4 sec. 1.

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start-ups, the preferred stock system remained immature.[45] With the emergence of the Measures, preferred stocks are off to a good start.

B. Why Did the China's Company Law Not Regulate Preferred Stocks?

One reason why the China's Company Law did not regulate preferred stocks may be traced back to the legislative history in 1990s. The aim of 1994 Company Law was not to promote the efficiency of stock market and free market, but to reform the state-owned enterprises.[46] The state intended to control the enterprises in certain key industries through owning the stocks. The preferred stocks could not satisfy such a purpose. However, as the stock market develops rapidly, the need for various financing tools is urgent.

Another reason is the corporate law theory hurdle. The existence of preferred stocks mechanism will challenge three main principles of the traditional civil law system: principle of shareholder equality (股东平等原则), capital majority rule (资本多数决), and three traditional capital principles (资本三原则).[47]

As a critical basis of corporate law, the principle of shareholder equality means each shareholder enjoys equal rights based on their shares, which is also known as one share one vote.[48] Preferred shareholders, however, do not own the same rights as the common shareholders, so the preferred shares system has such a theory barrier. Traditional corporate law is based on an assumption that all shareholders are homogenous and thus the idea of preferred shareholders with preferential rights may be unacceptable under traditional law regime.[49] With the develop-

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[45] *See* 曹立 (CAO LI), *supra* note 36, at 152.

[46] *See* 袁锦秀 (Yuan Jinxiu), 优先股股权优先及其相关问题透析—以法律为视角 [*The Priority of Preferred Stocks and Related Issues*], 湖北社会科学 [HUBEI SOCIAL SCIENCES], issue 1, at 152 (2006).

[47] *See* 冯威 (Feng Wei), 优先股市场实践与理论定位的背离及其制度完善 [*Market Practice and the Improvement on Preferred Stock*], 清华法律评论 [TSINGHUA LAW REVIEW], vol. 8 issue 2, at 196–199 (2015).

[48] *See* 赵旭东 (ZHAO XUDONG), 公司法学 [CORPORATE LAW], at 284 (3rd ed. 2012).

[49] *See* 汪青松 (Wang Qingsong), 赵万一 (Zhao Wanyi), 股份公司内部权力配置的结构性变革—以股东"同质化"假定到"异质化"现实的演进为视角 [*Structual Reform of Internal Power Allocation Within a Joint Stock Company: From*

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ment of corporate law, the principle of shareholder equality gradually takes into consideration of heterogeneous needs of shareholders.[50]

The capital majority rule requires the majority to trump based on the number of shares.[51] As preferred shareholders generally do not have voting rights, this principle cannot apply, either. This is on the ground of the principle of shareholder equality and economic efficiency.[52] As the principle of shareholder equality is amended, the capital majority rule also needs to consider various needs of shareholders.[53]

Furthermore, the three traditional capital principles demand the capital should be certain, maintained, and unchanged since the corporation is established through the charter.[54] With the characteristics of stocks and debts, preferred shares could be redeemed by the corporation, causing a big gap between the capitals written in the charter and the actual capitals.[55] The reform from paid-in capital system to subscribed capital system in 2013 Company Law[56] seemingly broadens the three traditional capital principles, which leaves a door for the development of preferred shareholders.

Due to legislative history in the 1990s and legal theory barriers, the development of preferred share was slow in the past.

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the Perspective of a Evolution from the Homogenous Shareholder Assuption to Actual Heterogeneous Shareholders], 现代法学 [MODERN LAW SCIENCE], issue 3, at 33–35 (2011).

[50] *See id.* at 36–38.

[51] *See* 朱慈蕴 (Zhu Ciyun), 资本多数决原则与控制股东的诚信义务 [*Majority Rule and Controlling Shareholders' Duty of Good Faith*], 法学研究 [CHINESE JOURNAL OF LAW], issue 4, at 107–08 (2004).

[52] *See id.*

[53] *See* 冯威 (Feng Wei), *supra* note 47, at 198.

[54] *See* 赵旭东 (ZHAO XUDONG), *supra* note 48, at 204–07.

[55] *See* JERRY W. MARKHAM, JOSE M. GABILONDO & THOMAS LEE HAZEN, CORPORATE FINANCE: DEBT, EQUITY, AND DERIVATIVE MARKETS AND THEIR INTERMEDIARIES 254 (3rd ed. 2011).

[56] For more detailed introduction of the reform, please see *China's New Company Registration Regime (Feb. 2014)*, LINKLATERS, www.linklaters.com/pdfs/mkt/shanghai/A17808716.pdf (last visited July 6, 2017).

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C. Preferred Stocks' Current Practice in China

Till the end of 2014, four pioneers, Agricutural Bank of China, Bank of China, Shanghai Pudong Development Bank, and Industrial Bank, have issued preferred stocks in a total amount of RMB 100 billion.[57] In the end of 2015, fourteen listed banks have disclosed their plans about issuing preferred stocks and seven of them have already issued the preferred stocks in Shanghai Stock Exchange and Shenzhen Stock Exchange.[58] Investors of the preferred stocks are mainly insurance companies, tobacco companes, and their affiliated assets management corporations, trust corporations, and so on, for these investors have sufficient cash flows and are unwilling to bear high risks.[59]

Since the Measures were enacted in March, Guanghui Energy Co., Ltd. ("Guanghui") in April 2014 first published its preferred share plan and later got approval from the CSRC. Guanghui is a private natural resources company and planned to raise a fund of 5 billion through preferred stocks. However, Guanghui was also the first company which had rejected the preferred stock plan in May 2015. According to Guanghui, the reason behind was the bank loan rates had been lowered twice by the central bank, leading to an increase of the cost of issuing preferred stocks.

D. The Necessity of Preferred Stocks in China

With the rapid development of China's capital markets, single common stocks system cannot satisfy the diversified needs of investors. As no law has clearly justified preferred stocks system, legal risks often arise when companies take similar financing measures, and the court may deny those measures with-

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[57] *See* 唐斌 (Tang Bin), 薛成容 (Xue Chengrong), "优先股"试点:观察与思考——四家银行优先股试点的收获与政策建议 [*Preferred Stock Pilot: Observations and Thoughts—Gains and Suggestions from Four Banks Preferred Stock Pilot*], 新浪财经 [FINANCE.SINA.COM], (July 28, 2015) *available at* http://finance.sina.com.cn/money/bank/bank_hydt/20150728/170622813253.shtml (last visited Jun. 25, 2017).

[58] *See* 张歆 (Zhang Xin), 16 家上市银行 15 家锚定优先股, 募资上限超 6000 亿元 [*15 out of 16 Listed Banks Targeted Preferred Stocks and the Funds are Over 600 Billion*], 搜狐财经 [BUSSINESS.SOHU.COM] (Dec. 15, 2015), *available at* http://business.sohu.com/20151215/n431308439.shtml (last visited Jun. 25, 2017).

[59] *See id*.

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out clear guidance of laws. A landmark case a few years ago proved such risks and the absolute necessity to include preferred share system in China's security market. In an appellant case Suzhou Haifu Investment Co., Ltd. v. Gansu Shiheng Resource Co., Ltd., etc. in 2012, Haifu Co., Zhongxing Co and other related parties entered into a capital increase agreement, in which they agree that if the net profit of Zhongxing Co. in 2008 fails to reach RMB 30 million, Haifu Co. is entitled to claim compensation from Zhongxing Co. and its shareholder.[60] The Supreme People's Court held that the special provision was invalid, because it has violated the law regarding risk sharing and it has damaged the company and the creditors' interests. In practice, a great amount of VCs have entered into similar contracts to expect steady returns.[61] The conflicts between practice and the legal barrier seriously impeded the financial markets. Therefore, it is highly essential to include preferred stocks in the current corporation law system.

In addition, preferred stock system can solve different problems for various investors. For VCs, it can eliminate information asymmetry and uncertainty, when VCs are investing in SMEs (Small and Medium-sized Enterprises).[62] For public investors who are averse and vulnerable to risks, preferred stock provides steady returns.[63] From the point of restricting the ownership of the state party, it is also a good choice for corporations to adjust the corporate governance and many U.S. and European companies have adopted a preferred stock system for this purpose.[64] The state could still receive dividends but deliver up the voting power. How to enforce the law and to request the state party to transfer its common stocks to preferred stocks is another interesting question which will not be discussed in this article.

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[60] *See* 苏州工业园区海富投资有限公司与甘肃世恒有色资源再利用有限公司、香港迪亚有限公司、陆波增资纠纷再审案 [Suzhou Haifu Investment Co., Ltd. v. Gansu Shiheng Resource Co., Ltd., etc.] (2012) 民提字第 11 号, (Supreme People's Ct. Nov. 7, 2012) CLI.C.3563911 CHINALAWINFO..

[61] *See* VC 和创业者签对赌协议——该是不该? (*VCs and Entrepreneurs Enter into Valuation Adjustment Mechanism Agreements—Should or Shouldn't?*), 投融界 [INVESTING AND FINANCING FIELDS] (Nov. 24, 2014), *available at* http://news.trjcn.com/detail_118578.html.

[62] *See* 朱慈蕴 (Zhu Ciyun), 沈朝晖 (Shen Zhaohui), *supra* note 16, at 149.

[63] *See* 张歆 (Zhang Xin), *supra* note 58.

[64] *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1358 (2008).

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III. PREFERRED SHAREHOLDERS' POTENTIAL RISKS

As the cash flow rights are separated from voting rights, minority shareholders are usually expropriated by the majority shareholders to a large degree. Preferred shareholders, which in general are minority shareholders, have to face the expropriation problem as well. To be specific, preferred shareholders will encounter the horizontal conflicts with the common shareholders, for the two groups hold different interests and preferences.

A. The Expropriation Problem

Minority shareholders may be opportunistically expropriated by majority shareholders through the majority's controlling power to maximize the majority's own welfare and deprive the minority of benefits.[65] It can also be described as "tunneling," which means transferring profits out of firms to benefit the controlling person.[66] The expropriation risk is the major principal-agent problem for corporations[67] and minority shareholders are usually not protected from such expropriation.[68] Especially, Claessens, Djankov, Fan and Lang (1999) have empirically proved this phenomenon in nine countries and areas of East Asia.[69]

Empirical evidence shows the expropriation has a positive relationship with the separation of cash flow rights from voting

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[65] *See* Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *On Expropriation of Minority Shareholders: Evidence from East Asia*, at 2 (Soc. Sci. Res. Network Working Paper, 1999), *available at* http://ssrn.com/abstract=202390 (last visited July 6, 2017).

[66] *See* Johnson Simon, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000).

[67] *See* Claessens et al., *supra* note 65, at 28. Lucian A. Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control 29 (Nat'l Bureau of Econ. Research Working Paper No. 7203, 1999), *available at* http://www.nber.org/papers/w7203.pdf. *See generally* Florencio López de Silanes, Rafael La Porta, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[68] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J.FIN. 471, 481(1999). *See also* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1644 (2006).

[69] *See* Claessens et al., *supra* note 65, at 2 (conducting empirical study in Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand).

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rights.[70] There are mainly three methods to separate cash flow rights from voting rights: differential voting rights, pyramid structures, and cross-ownership structures.[71] In a differential voting rights structure, shares are divided into two or more classes with different voting ratios.[72] For example, Class A share is one share one vote while one share of Class B enjoys ten votes.[73] Companies like Google, Facebook, New York Times and Alibaba have constructed such a structure to ensure control.[74] Similarly, preferred stock can be called as a form of dual-class structure: Class A is one share one vote and Class B is one share zero vote,[75] through which cash flow and voting rights are disconnected and expropriation may occur under such condition.

B. Preferred Shareholders' Horizontal Risks

Preferred shareholders who usually belong to minority shareholders may be expropriated. Even under some special circumstances where they are entitled to vote, they constitute a minority and cannot prevail or influence the board of directors.[76] Common shareholders are paid dividends depending on the profits of the company, while preferred shareholders realize gains from fixed dividends. Thus, a horizontal conflict is created.[77] Out

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[70] *See id.*

[71] *See* Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and the Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights,* at 3 (Nat'l Bureau Econ. Research, Working Paper No. 6951, 1999), *available at* http://www.nber.org/papers/w6951.pdf (last visited July 6, 2017).

[72] *See id.* at 4.

[73] *See* Sang Yop Kang, *Re-Envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace,* 16 U. PA. J. BUS. L. 843, 853 (2013–2014).

[74] *See* Matt Orsagh, *Dual-Class Shares: From Google to Alibaba, Is It a Troubling Trend for Investors?*, MARKET INTEGRITY INSIGHTS (July 6, 2017), *available at* https://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/

[75] Discussed with Professor Sang Yop Kang in his East Asia Economy Structure class.

[76] *See* Mitchell, *supra* note 4, at 473 n.157.

[77] Horizontal conflict is a conflict over limited corporate assets and ways of distribution. *See, e.g.*, Mitchell, *supra* note 13, at 1213; Rutherford B. Campbell, Jr., *A Positive Analysis of the Common Law of Corporate Fiduciary Duties,* 84 KY. L.J. 455, 460–62 (1996); Mitchell, *supra* note 4, at 445–46. Horizontal conflicts will also arise between bondholders and stockholders. *See generally* Mitchell, *supra* note 4, at 1213–28. In this paper, the term "horizontal conflict" is used in a general way and includes not only the type of "pure" horizontal

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of different interests, there is a great risk that the preferred shareholders will not get fair and maximum dividends from a corporation.[78]

Pure horizontal conflict is a direct conflict between preferred and common shareholders. In such a conflict, benefits of preferred shareholders may be transferred away[79] by the commons through the directors by way of the voting power.[80] Moreover, under limited wealth, allocation of corporation wealth is a zero-sum game: one gets more, the other gets less.[81] For example, in a potential merger and acquisition case, preferred shareholders with fixed dividends may oppose such merger as they are afraid to be squeezed out with limited dividends; however, the common shareholders favor the completion of the merger with possibility of obtaining more profits. The directors are voted by the common shareholders in board elections and owe fiduciary duty to common shareholders. Therefore, these directors often act in the interests of the common shareholders[82] and will likely facilitate the merger under this circumstance.[83]

Another type of horizontal conflicts involves some vertical elements when the directors own common stocks.[84] This is similar to pure horizontal conflicts as directors will still favor interests of the common shareholders with an amount of common shares at hand. However, when directors own both common shares and preferred shares, they can make a great argument for their illegal conducts: the decisions they make are based on all shareholders' interest instead of the common shareholders' because they themselves also own preferred stocks.[85] Through this, they can successfully disguise their intention against the interests of the pre-

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conflict, where the conflict is purely between common and preferred shareholders, but also the conditions when director owns certain amount of common shareholders.

[78] *See* 朱慈蕴 (Zhu Ciyun), 沈朝晖 (Shen Zhaohui), *supra* note 16, at 155.

[79] *See* Campbell, *suora* note 77, at 469.

[80] *See* McEllin, *supra* note 23, at 902–03.

[81] *See* LAWRENCE E. MITCHELL ET AL., CORPORATE FINANCE AND GOVERNANCE 653 (2006).

[82] *See* Holladay, *supra* note 15, at 102. *See also* Mitchell, *supra* note 4, at 450.

[83] *See* McEllin, *supra* note 23, at 902–03.

[84] *See id.* at 904–05.

[85] *See, e.g.*, *Jedwab*, 509 A.2d at 595 (defendants arguing that their decision to offer common shareholders four dollars per share more than preferred shareholders was fair because they also owned preferred shares).

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ferred shareholders to maximize their private benefits.

The common shareholders can exploit preferred shareholders by making risk decisions to bet a big gain[86] or eliminating the preferred shareholders' dividends.[87] To be specific, the elimination of arrears from the preferred shareholders mainly takes a number of ways.[88] First, to amend the charter to eliminate the dividend arrears,[89] which have been accumulated for a long time when companies are unable to pay dividends to preferred shareholders. Once the financial condition of the company turns well, the common shareholders may call a shareholder meeting to eliminate those preferred arrears so that they can receive dividends without without first paying the shareholders of preferred shares.[90] The second way is through a "dummy" merger or white-out merger.[91] The company first establishes a shell subsidiary and enters into a merger agreement with the subsidiary, leaving the shell company surviving. In the merger agreement, the shares of original company including all commons and preferred shareholders are transferred into the new company, through which the preferred arrears are stripped.[92] Moreover, the preferred shareholders may be frozen in a dormant firm without any profits.[93]

It is the control power of common shareholders and vulnerable status of minority shareholders that lead to frequent expropriation. This phenomenon is especially serious in China, where the state actor State-owned Assets Supervision and Administration Commission of the State Council ("SASAC") is one of the controlling shareholders and the supervision and management in SASAC are inefficient and disordered.[94] Some scholar

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[86] *See* Walther, *supra* note 1, at 167–73.

[87] *See id.* at 167–76.

[88] *See* Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1208–19 (2013).

[89] *See* Jeffrey S. Stamler, *Arrearage Elimination and the Preferred Stock Contract: A Survey and a Proposal for Reform*, 9 CARDOZO L. REV. 1335, 1337–38 (1988).

[90] *See* Korsmo, *supra* note 87, at 1177.

[91] *See* Federal United Corp. v. Havender, 11 A.2d 331, 333–35 (Del. 1940).

[92] *See* Bratton & Wachter, *supra* note 24, at 1830.

[93] *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 32 (2005).

[94] *See* 龚博 (Gong Bo), 以优先股制约国有控股的制度设计 [*Limiting the State-Owned Enterprise System by Using Preferred Stocks*], 法学 [LAW SCIENCE], issue 10, at 69 (2012).

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argues that the risks do not exist when the investors are VCs, because VCs through staged investment usually hold enormous power and do not need special protection.[95] This article agrees with this opinion but will not make such a distinction herein.[96]

In sum, horizontal conflict arises for the common and preferred shareholders hold different interests. Lacking control power, preferred shareholders are usually expropriated by the common shareholders and directors. Especially, directors and common shareholders can well disguise their intention against the interests of the preferred shareholders when they own both common and preferred stocks.

IV. PROTECTION OF PREFERRED SHAREHOLDERS

Protection of preferred shareholder is vital to corporate governance and the national capital markets, for this is an important aspect to attract investors. However, Chinese current rules and U.S. practice are not sufficient to provide meaningful protection. Thus, a new model is highly expected to be built up to protect preferred shareholders, especially in current China where the preferred stock mechanism just takes root.

A. Protection of Minority Shareholders Is Vital to Corporate Governance

Minority shareholder protection is at the heart of the corporate governance[97] and so called as the "legal DNA of good economies."[98] The protection of preferred shareholders which

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[95] *See* Korsmo, *supra* note 88, at 1208–19.

[96] As the preferred shareholder system just initiates, the first concerned question should be how to protect the large group of vulnerable preferred shareholders. The next question is then what kind of preferred shareholders may not need such protection. Therefore, this paper does not distinguish the venture capitalists and unsophisticated investors.

[97] *See, e.g.*, Adolf A. Berle, Jr., *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212, 1212 (1958) (recognizing the rules of corporate law are primarily toward the protection of minority stockholders); Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119, 123 (2003–2004); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000) ("Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders.").

[98] *See* David Wessel, *The Legal DNA of Good Economies*, WALL ST. J. (Sept. 6, 2001 9:41 AM), *available at* http://www.wsj.com/articles/

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belong to minority shareholders is also vital to corporate governance.[99]

Four influential economists La Porta, Lopez-de-Silanes, Shleifer, and Vishny ("LLSV") have demonstrated that protection of minority shareholders can indicate success of a national capital market and the condition of corporate governance.[100] As for a state which does not provide sufficient protection for minority shareholders, it would be less attractive to investors and would have significantly smaller capital market.[101] Therefore, legal regimes which protect minority shareholders and constrain tunneling are vital in furthering capital market development.[102] Similarly, as for a corporation with inadequate protection for minority shareholders, controlling shareholders would exploit private benefits from the minority with no barriers. As a result, such a corporation will be caught into a bad business condition and even ruin its reputation, making it less attractive to investors as well.[103]

For the reasons stated above, it is urgent to build reasonable protection mechanisms to protect preferred shareholders who are usually considered as minorities.

B. Protection of Preferred Shareholders Under China's New Rule

The Measures is the first and most complete and specified legal document that explicitly acknowledges the preferred stocks system. Although it is only a department rule enacted by a State Council department, this means significantly to China's stock market. The Measures have 70 articles in total, including nine parts: general instructions, the rights of preferred shareholders, listed corporations issuing preferred stocks, unlisted corporations issuing preferred stocks in a private way, registration, disclosure,

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[99] As the Measures currently only allow listed corporations to issue preferred stocks, therefore this paper only discusses the protection of preferred shareholders in public corporations. The protection in close corporations is another import issue which will not be discussed in this paper.

[100] *See, e.g.*, La Porta et al., *supra* note 67; La Porta et al., *supra* note 10; Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); La Porta et al., *supra* note 97.

[101] *See* La Porta et al., *supra* note 67.

[102] *See* Simon et al., *supra* note 66, at 22.

[103] *See* Gilson, *supra* note 10, at 1648.

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redemption and merger and acquisition , supervision and liability, and appendix.

The Measures allow i) listed corporations to issue preferred stocks publicly; 2) listed corporations to issue preferred stocks to qualified investors in a non-public way; and 3) unlisted public company to issue preferred stocks to qualified investors in a non-public way.[104] Requirements for listed corporation to issue preferred stocks publicly are: the common shares belong to SSE 50 Index,[105] paying considerations by issuing preferred stocks when purchasing or merging other listed corporations, or paying considerations by issuing preferred stocks when repurchasing common shares in order to decrease their capital contributions.

1. Protections of Preferred Stockholders Stipulated by Law

Rights covered in law are mandatory and more economically efficient compared to the rights covered in contract through bargain. The Measures have provided several ways to protect the rights of preferred shareholders, including total amount restriction, voting rights on vital issues, resuming voting rights on exceptional occasions, and redemption rights.

(a) Total Amount Restriction

In article 23,[106] the rule prohibits the corporation to issue preferred stocks more than 50% of the total amount of common stocks, and the funds raised should not be more than 50% of the net assets.[107] The legislation sets up a mechanism to prevent the risks of preferred stockholders in advance. If the volume of pre-

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[104] 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] arts. 3, 34, 43.

[105] SSE 50 Index is a stock index made by Shanghai Stock Exchange. It is consisted of 50 large corporations with good liquidity listed in Shanghai Stock Exchange and it can reflect the market trend of large and influential corporations. *See* SSE 50, *available at* http://wiki.mbalib.com/wiki/%E4%B8%8A%E8%AF%8150%E6%8C%87%E6%95%B0.

[106] 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] art. 23.

[107] *See id*. About the percentage, different countries choose different limits. For example, France is 3/4, Italy and Japan are both 1/2. *See generally* 宋伟 (Song Wei), 胡海洋 (Hu Haiyang), 优先股相关法律问题透析 [*Some Problems in Preferred Shareholders*], 法治研究 [RESEARCH ON RULE OF LAW], issue 9 (2009).

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ferred shares is too large, the corporation would bear much burden, for the preferred shares are calculated in corporation's equity before tax.

(b) Voting Rights on Vital Issues

According to article 10, the preferred shareholders would have the voting rights on five vital issues, i.e., amending corporation charter about preferred stocks, decreasing the registered capital more than 10%, changing the corporate structure (such as merger, division, dissolution, and so on), issuing preferred stocks, and others as specified in the charter. To decide any one of the above five important circumstances, both common stockholders and preferred stockholders need 2/3 majority votes.[108] This is so called class voting right.

Compared to ordinary voting right, class voting means a special class shareholder meeting separated from the ordinary shareholder meeting. The rationale behind the class voting system is that nobody can limit others' rights. Common shareholders cannot constraint rights or set up obligations for preferred shareholders, so preferred shareholders may participate and express their opinions through their voting rights.[109]

(c) Resuming Voting Rights When not Paid Dividend

Preferred stockholders would resume their voting rights when the company does not pay them dividends for accumulative three years or consecutive two years.[110] This is an ex post facto protective mechanism. The resumed voting rights are not limited in the five issues listed in the article 10.

(d) Redemption Rights

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[108] 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] art. 23.

[109] *See* 刘胜军 (Liu Shengjun), 类别表决权：类别股股东保护与公司行为自由的衡平—兼评《优先股试点管理办法》第 10 条 [*Class Voting: Balance of Protection of Class Shareholders and Freedom of Corporation Conducts-Comments on Art. 10 of Pilot Measures for the Administration of Preferred Stock*], 法学评论 [LAW REVIEW], issue 189, at 100 (2015).

[110] 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] art. 11.

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The redemption rights could be at the company's or at the investor's option according to article 13.[111] When a company requires redeeming the preferred stocks, it shall pay all accrued dividends to the investors.[112] This article prescribes redemption rights but fails to identify the different procedures of redemption that are required by the company or by the investor.

2. Protections of Preferred Stockholders Stipulated by Charter

Not only strictly stipulated in law, some rights can also be bargained in the article of incorporation. The charter should specify the ratio and condition when the preferred shareholders join allocating profits with common shareholders after being paid agreed dividends.[113] The charter could stipulate other situations that the preferred shareholders have voting rights except under the four mandatory conditions.[114] When resuming the voting rights, the charter can stipulate different voting ratio per preferred shares.[115] Furthermore, the charter can include more circumstances to resume the voting rights.[116] Additionally, the charter also could stipulate the specific conditions of redemption.[117] The Measures seem to grant the charter great autonomy under many situations.

Which rights should be prescribed by law and which rights could be included in charter? Professor Melvin Eisenberg provided an answer. He divided rules into three categories: enabling rules, default rules, and mandatory rules.[118] Enabling rules empower the corporation to apply rules in a specific way. Default rules are defined rules unless corporation adopts other rules otherwise. As for mandatory rules, corporations shall not vary the rules by themselves. Application of these rules depends on the rule's subject matter: structural, distributional, and fiduciary rules.[119] Structural rules control the allocation of deci-

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[111] *Id.* art. 13.
[112] *Id.*
[113] *Id.* art. 9.
[114] *Id.* art. 10(5).
[115] *Id.* art. 11.
[116] *Id.*
[117] *Id.* art. 13.
[118] *See* Eisenber, *supra* note 18, at 1461.
[119] *Id.*

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sion-making power among different corporate actors and the conditions to exercise such decision-making power. Distributional rules govern the distribution of assets and dividends to shareholders. Fiduciary rules govern the duties of directors and managers to shareholders.[120] Professor Eisenberg held the opinion that in publicly held corporations and the corporations that are going to be listed, key fiduciary rules and structural rules need to be subject to law while distributional rules could be bargained by the charter.[121] As illustrated in the Jedwab case later in Part IV.C., directors shall entail fiduciary duty to preferred shareholders when the rights are equally shared with the commons. This is consistent with Professor Melvin Eisenberg's analysis.

In China's new administrative rule, the rules about voting rights on vital issues, resuming voting rights on exceptional occasions, total amount restriction and redemption rights all belong to structural rules which are about the allocation of decision-making power and the conditions to exercise such power. They are proper to be governed by law. However, there are no rules about fiduciary rights stipulated in the law. What kind of the fiduciary duties do the managers owe to the preferred shareholders? On what rights the managers have fiduciary duties? The law is silent in this regard. As for distributional rules, the Measures seemingly leave much room to corporate actors in the charter, but they cannot yet be freely bargained in the charter given that the Measures do not empower them to do so.

C. Protection of Preferred Shareholders in the United States

1. The U.S .Model Law and Case Law

The preferred stocks system in the U.S. is well strucrured and most rules about preferred stocks are established through contracts instead of written mandatory laws. Model Business Corporation Act ("MBCA"), a model law followed by 24 states,[122] only has three articles about preferred stocks. §6.01

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120 *Id.*

121 *Id.* at 1462.

122 *See* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 844 (2005). *See also* 2016 Revision of Model Business Corporation Act (Corporate Laws Committee of the Business Law Section of the American Bar Association, Jun. 2016).

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authorizes the articles of incorporation to prescribe different classes of shares, including preferred shares. The preferred shares can be redeemable, convertible, or cumulative, and can have preference over other classes of shares.[123] §6.02 allows the board of directors without shareholders' approval to issue the preferred stocks if the charter so provides.[124] Furthermore, §10.04 is regarding that the preferred shareholders could resume the voting rights under some exceptional situations.[125]

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[123] MODEL BUS. CORP. ACT § 6.01 (2016):

"(c) The articles of incorporation may authorize one or more classes or series of shares that:

(1) have special, conditional, or limited voting rights, or no right to vote, except to the extent otherwise provided by this Act;

(2) are redeemable or convertible as specified in the articles of incorporation:

(i) at the option of the corporation, the shareholder, or another person or upon the occurrence of a specified event;

(ii) for cash, indebtedness, securities, or other property; and

(iii) at prices and in amounts specified, or determined in accordance with a formula;

(3) entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partially cumulative; or

(4) have preference over any other class or series of shares with respect to distributions, including distributions upon the dissolution of the corporation."

[124] *Id*. §6.02:

"(a) If the articles of incorporation so provide, the board of directors is authorized, without shareholder approval, to:

(1) classify any unissued shares into one or more classes or into one or more series within a class,

(2) reclassify any unissued shares of any class into one or more classes or into one or more series within one or more classes, or

(3) reclassify any unissued shares of any series of any class into one or more classes or into one or more series within a class."

[125] *Id*. §10.04:

"(a) If a corporation has more than one class of shares outstanding, the holders of the outstanding shares of a class are entitled to vote as a separate voting group (if shareholder voting is otherwise required by this Act) on a proposed amendment to the articles of incorporation if the amendment would:

1.effect an exchange or reclassification of all or part of the shares of the class into shares of another class;

2. effect an exchange or reclassification, or create the right of exchange, of all or part of the shares of another class into shares of the class;

3. change the rights, preferences, or limitations of all or part of the shares of the class;

4. change the shares of all or part of the class into a different number of shares of the same class;

5. create a new class of shares having rights or preferences with respect

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Aside from model law, the highly influential Delaware Chancery decision of Jedwab v. MGM Grand Hotels has established a general rule regarding preferred shareholders' protection.[126] In this case, the preferred shareholders sought to prevent a proposed merger of the corporation because the benefits of the merger would be allocated unfairly among the common and the preferred shareholders.[127] Delaware Court of Chancery held that: if preferential rights are invoked, directors' duty to preferred shareholders is contractual based on charter and preferred stock certificate; if, however, the rights are ones shared with the common stockholders, the duty owed to preferred shareholders is same as the fiduciary duty owed to the commons.[128]

Prior to the Jedwab decision, the rights stipulated in the stock certificate or company charter are the only rights of preferred shareholders.[129] The Jedwab rule extends the scope of the rights of preferred shareholders and guarantees more protection for preferred shareholders.[130] It emphasizes the same fiduciary duty the managers owed to preferred shareholders as to the common. More importantly, this rule answers that the mangers entail fiduciary duties to the preferred shareholders for the rights that preferred shareholders equally share with the commons. In addition, for the preferential rights, the managers do not have fiduci-

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to distributions that are prior or superior to the shares of the class;

6. increase the rights, preferences, or number of authorized shares of any class that, after giving effect to the amendment, have rights or preferences with respect to distributions that are prior or superior to the shares of the class;

7. limit or deny an existing preemptive right of all or part of the shares of the class; or

8. cancel or otherwise affect rights to distributions that have accumulated but not yet been authorized on all or part of the shares of the class."

[126] *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing the contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.").

[127] *Id*. at 587.

[128] *Id*. at 594. *See also* McEllin, *supra* note 23, at 908.

[129] *See* Rothschild Int'l Corp. v. Liggett Grp., Inc., 474 A.2d 133, 136 (Del. 1984) ("Preferential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation.").

[130] *See* McEllin, *supra* note 23, at 910.

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ary duties; instead, all preferential rights are included in the contract through bargain. This framework is generally applied not just in Delaware, but in most states throughout the U.S.[131]

In conclusion, the U.S. prefers imposing mandatory fiduciary duties on rights equally shared with common shareholders, and relying on the contract to bargain the preferential rights.

2. The U.S. Application

The U.S. rule on preferred shareholders protection provides insightful experience for China: imposition of mandatory fiduciary duty may solve possible horizontal conflicts between preferred shareholders and common shareholder, because the directors will take preferred shareholders' benefits into consideration when making decisions. This is also consistent with Professor Melvin Eisenberg's view on mandatory fiduciary duties.[132]

However, the U.S.'s subsequent application seemingly deviated from Jedwab court's original intent to provide full protection to preferred shareholders.[133]

While the directors must balance the interests between the common and the preferred shareholders, they usually would favor the commons because the commons have rights to vote in the elections.[134] The board of directors sometimes can be well protected by business judgment rule[135] despite the fact they have made biased decisions detrimental to preferred shareholders.[136] If the directors "acted on an informed basis, in good faith and in the

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[131] *See, e.g.*, 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5295 (perm. ed., rev. vol. 2009).

[132] *See* Eisenber, *supra* note 23, at 1473–74 (pointing out that core fiduciary rules should be mandatory because agents' interests may materially diverger from the interests of principals and should not unilaterally determine the rules that govern the divergencies of interest).

[133] *See* McEllin, *supra* note 23, at 910–11.

[134] *See, e.g.*, Holladay, *supra* note 15, at 96; Amazon.com, Inc. v. Hoffman, 2009 WL 2031789, *3 (Del. Ch. Jun. 30, 2009); McEllin, *supra* note 23, at 912–13.

[135] A court "will not substitute its own notions of what is or is not sound business judgment" if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *See Aronson*, 473 A.2d at 812. *See also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

[136] *See* Holladay, *supra* note 15, at 102. *See also Robinson*, 566 F. Supp. at 1084.

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honest belief that the action taken was in the best interests of the company,"[137] the courts will not overrule such a decision unless the preferred shareholders make a convincing rebuttal of the business judgment presumption.[138]

Furthermore, Jedwab has created a "paradox" in determining the scope of preferential rights: the contract is usually defined and interpreted by directors, through which directors could easily decide the scope of their own fiduciary duties.[139] The cases after Jedwab confirmed the concern that the contractual rights have been strictly limited.[140] What's worse, based on the idea of "fiduciary duty trumps contract,"[141] the fiduciary duty that the directors owe to the commons can trump the contractual duty that the directors owe to the preferred shareholders whenever the two obligations conflict with each other, even if the charter or the preferred stock certificate has expressly addressed the disputed issues.[142]

In sum, according to the U.S. current practice, preferred shareholders seldom enjoy sufficient protections. It is hard for preferred shareholders to request valid fiduciary duties claims on directors under the presumption of business judgment rule. Moreover, the contractual "preferential" rights of preferred shareholders may be interpreted very narrowly and may be trumped by fiduciary duty when these two duties are in conflict. Therefore, a new and meaningful framework to protect preferred shareholders is highly expected.

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[137] *See Aronson*, 473 A.2d at 812.

[138] If the challenging party is able to prove that board of directors lack independence or otherwise breached fiduciary duties when making decisions, then the business judgment rule's presumption can be overcome and the court will apply the "entire fairness doctrine." As a result, the burden of proof shifts to the corporation to demonstrate both price and process are fair to the shareholders of the corporation. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); *Aronson*, 473 A.2d at 812; Krasner v. Moffet, 826 A.2d 277, 287 (Del. 2003).

[139] *See* Mitchell, *supra* note 4, at 448–49.

[140] *See, e.g.*, HB Korenvaes Investments v. Marriott Corp., 19 Del. J. Corp. L. 748, 751, 771–75 (Del. Ch. July 1, 1993); Quadrangle Offshore (Cayman) LLC v. Kenetech Corp., No. 16362NC, 1999 WL 893575, at *8–12 (Del. Ch. Oct. 13, 1999); Elliott Associates, L.P. v. Avatex Corp., 715 A.2d 843, 852–53 (Del. 1998).

[141] *See* Mitchell, *supra* note 4, at 458–59.

[142] *See* McEllin, *supra* note 23, at 917–19. *See, e.g., In re* Trados Inc. Shareholder Litigation, No. 1512–CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009).

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D. Proposed Models to Protect Preferred Shareholders

Many scholars have proposed various methods to provide meaningful protections to preferred shareholders:

1. Contractarian View

Some contractarians advocate that shareholders and managers should be able to determine all rights and duties contractually, not by imposing mandatory duties.[143] Contractarians support their view by citing economic benefits of freedom of contract and personal autonomy.[144] Additionally, when all terms are defined on the written contract, informational asymmetry problem will be less severe.[145]

However, this view has attracted much criticism. First, the preferred stock certificates are usually unilaterally drafted by the corporation, leaving preferred no room to bargain.[146] Even preferred shareholders occasionally have chance to bargain over the contractual terms, they are in a disadvantaged position with little bargaining power.[147] Second, when the contract is to be interpreted, directors are the first ones to interpret the terms. And In most cases, directors will interpret the terms concerning preferred shareholder protection in a restricted way.[148] Moreover, the U.S. case law has revealed the courts' strict interpretation on preferred stock contract as discussed above in Part IV.C.2. In current China, the contractarian's approach does not seem to be a proper model for preferred shareholder protection.

2. Imposition of Fiduciary Duty by Contract

Professor Lawrence Mitchell supports the imposition of

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[143] *See* Rutherford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 562 (1996). *See* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 93 (1991).

[144] *See* Campbell, *supra* note 143, at 565–67.

[145] *See* McEllin, *supra* note 23, at 920–21.

[146] *See* Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445, 448 (1973).

[147] *See* Holladay, *supra* note 15, at 103.

[148] *See* Mitchell, *supra* note 4, at 473.

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mandatory fiduciary duties by incorporating a fiduciary duty covenant in the preferred stock contract.[149] This way has expanded the traditional scope of contract interpretation to some extent.[150] Through including the fiduciary duty in the contract, directors would be discouraged to infringe preferred shareholders' rights. Besides, preferred shareholders will receive more protection from mandatory fiduciary duties than through contract because "fiduciary duty trumps contract."[151] It means that before examining whether the disputed contents are allowed in the contract, the first question needed to be answered is whether the action is fair.[152] Furthermore, mandatory fiduciary duty, as a valuable public benefit, can reduce the transaction costs by providing a bottom line for parties to follow, rather than leaving parties much freedom to bargain.[153]

Nevertheless, this approach is viewed as an "interim" solution by Professor Mitchell,[154] because it has the same problem as contractarian's approach: the covenant of fiduciary duty is not very realistic to be included in the preferred shareholders contract due to the existence of large power disparity.[155] In spite of this, investors will choose corporations whose contract has incorporated a covenant of fiduciary duty. Market power will take effect when the investors are making decisions.

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[149] *See* Mitchell, *supra* note 4, at 476 (providing a possible template of the covenant incorporating fiduciary duty: "The Corporation shall not in any manner, whether by amendment of the Certificate of Incorporation (including, without limitation, any Certificate of Designation), merger, reorganization, recapitalization, consolidation, sales of assets, sale of stock, tender offer, dissolution or otherwise, take any action, or permit any action to be taken, solely or primarily for the purpose of increasing the value of any class of stock of the Corporation if the effect of such action is to reduce the value or security of the Preferred Stock.").

[150] *See* McEllin, *supra* note 23, at 923.

[151] *See* Mitchell, *supra* note 4, at 459.

[152] *See* Holladay, *supra* note 15, at 104.

[153] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444–45 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1593 (1989) ("[A] stable conception of fiduciary duty develops only through applying a single standard across a great range of cases. Such a baseline represents a valuable public good, since the verbal formulas and the standards would vary considerably in the absence of a mandatory rule."); STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 30–31 (2008).

[154] *See* Mitchell, *supra* note 4, at 476.

[155] *See* McEllin, *supra* note 23, at 926.

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3. Imposition of Fiduciary Duty by Law

A similar way is to impose such mandatory fiduciary duties through written law as noted by Professor Melvin Eisenberg.[156] Through mandating fiduciary duty in law, the directors' opportunistic actions can be prohibited to a large degree, for the directors cannot unilaterally determine or materially modify the fidicuary rules.[157] Moreover, some scholar argues that the administrative agencies need to step in and enforce the fiduciary duties in the interest of preferred shareholders.[158] However, this proposal calls for amendments to the law, which is more difficult than incorporating such covenants in a contract.[159]

Some may argue the Company Law has already imposed the mandatory fiduciary duty on directors for preferred shareholders from the view of statutory interpretation[160]: 1) preferred shareholders are shareholders; 2) shareholders are the owners of the company; 3) directors shall undertake the fiduciary duty to the company according to Article 147 of Company Law (2014);[161] 4) therefore, directors shall owe the fiduciary duty to the preferred shareholders. This seems very logical. However, no related practice currently has proved such inference, so it is hard to say whether this works. As the previous U.S. case law has shown,[162] without mandatory fiduciary duty, there will be increased uncertainty and wasted costs in dealing with the protection of preferred shareholders.

4. A Special Committee

The fourth solution is to create a special committee to rep-

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[156] *See* Eisenber, *supra* note 18, at 1473–74 (pointing out that core fiduciary rules should be mandatory because agents' interests may materially diverger from the interests of principals and should not unilaterally determine the rules that govern the divergencies of interest).

[157] *See id*.

[158] *See* Brudney, *supra* note 146, at 487.

[159] *See* Walther, *supra* note 1, at 166.

[160] *See* 朱慈蕴 (Zhu Ciyun), 沈朝晖 (Shen Zhaohui), *supra* note 16, at 151. *See also* 刘胜军 (Liu Shengjun), *supra* note 109, at 101.

[161] 公司法 [Company Law] art. 147 ("The directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaw. They shall bear the obligations of fidelity and diligence to the company.").

[162] *See* Part IV.C.2.

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resent different classes of stocks.[163] The special committee, as representatives of preferred shareholders, can speak out their voices and demands and may even fight for their legitimate rights in the board. However, it remains unclear who will be the members of this special committee and to what extent this committee could fight for the preferred shareholders.

5. Divided Board Control

Divided board control means the board control is divided into two parts: right to elect the majority of board and right to elect the directors in compensation committee.[164] Preferred shareholders are conferred the power to elect the board while the common shareholders enjoy the exclusive power to elect the directors on the compensation committee.[165] This approach does not require preferred shareholders to obtain the total control over the board, which is unrealistic under most circumstances.[166] Preferred shareholders only hold the ability to "encourage adequate management" by replacing the existing board, so that they can be well protected against the exploitation from the directors.[167] Meanwhile, the common shareholders own the exclusive compensation authority and continue to enjoy fiduciary rights so that they can persuade the directors to take risky and profitable actions.[168] This is similar to the special committee as described above, as both solutions require certain involvement of preferred shareholders in the decision-making process.

This is a novel solution proposed by Professor Ben Walther. He argues that such divided board control compels the common and preferred shareholders to cooperate with each other as both parties hold certain power in the board and the board has to balance the different interests.[169] Another great benefit of this solution is that this is workable under current law with no need to

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[163] *See* LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 445–47 (Del. Ch. 2010).

[164] *See* Walther, *supra* note 1, at 202.

[165] *See id.* at 202–06.

[166] When the investors are venture capitalists, they may control the board through staged investing. *See* Korsmo, *supra* note 88, at 1210–11.

[167] *See* Walther, *supra* note 1, at 203.

[168] *See id.* at 205.

[169] *See id.* at 166.

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change current law.[170] Objectors may argue that this divided board control is hard to implement within a company, because preferred shareholders are in a weak bargaining position. This is similar to the imposition of fiduciary duty by contract. Including such divided board control, a company will be more attractive to the investors and will thus receive more funding.

In sum, the contractarians argue for determining all rights and duties through contracts while this cannot provide meaningful protection for preferred shareholders, as they own little bargaining power and court has the tendency to interpret those terms strictly. The imposition of fiduciary duty can well discourage directors' opportunistic actions and court's too limited interpretation; however, instead of making this into written law, incorporating the covenant of fiduciary duty into the contract is more realistic. Furthermore, creating a special committee is a viable solution to protecting the preferred shareholder's legitimate rights. At last, a novel solution of divided board control has empowered the preferred shareholders to elect the majority of board and left the common with sole compensation authority and fiduciary rights.

Under the current framework of laws and regulations, this article suggests that a company incorporate the fiduciary duty in preferred stock contract to make it more attractive, or involve preferred shareholders in the decision-making process of a company through building a special committee or dividing the board control to leave the power of electing board to the preferred and the power of compensation to the common.

6. Suggested Ways to China's New Rule on Protection of Preferred Shareholders

China's new rule has some rewarding articles and great significance on its thriving stock market, yet it also leaves much empty room and needs further specific rules. This article offers the following suggestions.

The first thing China should do is to make the rules on preferred stocks national binding law. As China's Legislation Law (2015 amended) expresses in article 88, national law has higher

[170] *See id.*

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legal authority than administrative regulations and administrative rules, and administrative regulations has higher legal authority than administrative rules.[171] The Measures here only count as an administrative rule authorized by an administrative body—CSRC. The legislative and judiciary disorders in 1990s are exact examples.[172] Once the lower level rules are in conflict with upper level laws, odds are good that the rules are to be announced invalid.[173] This article advocates that the preferred stock system needs to be added in the Company Law revised by the National People's Congress to guarantee the legality and clarity of preferred stocks system.

The second suggestion is to include mandatory fiduciary duty into written law. According to Professor Melvin Eisenberg, it is essential to include mandatory fiduciary rules in written law, otherwise the legal rights that preferred shareholders could have enjoyed cannot work well.[174]

Third, the Measures should explicitly empower the charter to set up distributional rules, making those rules into enabling rules and giving freedom to the parties. The new rule seems to leave large room in the charter. However, it actually does not. As for many distributional rules, if the law does not empower the charter, the parties cannot even bargain those terms. The following are suggested distributive rules that should be empowered by law and left to be bargained by charter:

The current rule only covers the voting rights on vital issues, but keeps silent on when and how to hold a preferred shareholders' meeting. This article suggests this meeting is separated with the ordinary one and the preferred shareholders enjoy the same right as the common ones to call an interim meeting.[175] Separation from the ordinary meeting would result in economic efficiency and motivation of preferred shareholders. If the meeting is specifically focused on the rights of preferred shareholders, there would be greater possibility that they would participate in the meeting and realize the voting rights. In addition, with the sepa-

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[171] 立法法(2015 修订) [Law on Legislation (2015 Amendment)] art. 88.
[172] *See* Part II.B.
[173] 立法法(2015 修订) [Law on Legislation (2015 Amendment)] art. 96.
[174] *See* Eisenber, *supra* note 18, at 1461.
[175] 公司法 [Company Law] art. 100 (empowering more 10% shareholders to call an interim meeting). *See generally* 宋伟 (Song Wei), *supra* note 107.

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rated meeting, preferred shareholders should enjoy the right to call an interim meeting when their rights are injured by the commons or the directors.

Article 33 of the Measures has restricted listed companies to issue the convertible preferred stocks.[176] Convertible preferred stocks are stocks that include an option for the stockholders to convert the preferred shares into common shares at some point and the preferred shareholders are entitled to receive a certain amount of the proceeds before the common stockholders.[177] In the U.S., the VC typically takes the form of convertible preferred stock when investing portfolio companies.[178] Such a restriction will seriously discourage companies from issuing and buying preferred stocks and will limit the liquidity of the stocks, which is detrimental to the stock market. This article suggests China's new rule to allow the convertible preferred stocks and to leave the option to the charter as a distributional rule.

Article 6 bans different preferred stocks in dividend allocation and residual property allocation. As the preferred stocks just came out, the legislation tends to set a homogeneous preferred stock. However, many countries empower the charter to stipulate different preferred stocks[179] and a similar rule about the different kinds of preferred stocks also exist in the 1992 rule.[180]

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[176] *See* 优先股试点管理办法 [Measures for the Administration of the Pilot Program of Preferred Shares] art. 33. However, a commercial bank may, based on capital regulation provisions, issue in a non-public manner the preferred shares which could be coercively converted into the ordinary shares in case of a trigger event and abide by applicable provisions.

[177] *See* Korsmo, *supra* note 88, at 1173.

[178] *See, e.g.*, Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1072 (2003); Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003).

[179] Japan's Commercial Code art. 222(1) prescribes various kinds of preferred stocks. Taiwan has similar rules. *See generally* 沈朝晖 (Shen Zhaohui), 公司类别股的立法规制及修法建议 [*Opinions to the Legislation on Classified Stocks*], 证券法苑 [SECURITY LAW], issue 5 (2011).

[180] 股份有限公司规范意见 [Opinions on Standards for the Companies Limited by Shares] art. 23.

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V. CONCLUSIONS

Protection of preferred shareholders is highly vital to corporate governance. Without changing the current framework of law, imposition of fiduciary duty in preferred contract, building a special committee, or divided board control are great ways to mitigate the horizontal conflicts between common and preferred shareholders. In terms of amending the legal framework, a binding national legal authority on preferred stocks is strongly recommended and the imposition of mandatory fiduciary duties needs to be included in the written law. Furthermore, the law needs to empower the charter to change distributional rules into enabling rules such as: holding preferred shareholders' meetings, issuing the convertible preferred stocks, allowing different preferred stocks in dividend allocation and residual property allocation.

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Jail Time is Not a Cure: Misguided Efforts in Prioritizing Prosecution Against Individuals Under the FCPA Context

LI Mengshi[*]

ABSTRACT

*The Foreign Corrupt Practices Act ("**FCPA**") regulates the conducts of both companies and individuals. However, few individuals were held accountable and the penalties were minimal compared with corporate prosecutions. There has been an outcry of criticisms accusing the agencies of going the wrong direction, holding the belief that the only way to reduce bribery overseas is to jail individuals responsible. Even if the enforcers extract large fines from companies, companies would only treat this as a cost of doing business.*

*Witnessing a decrease of individual FCPA enforcements compared with corporate actions, the Department of Justice ("**Department**" or "**DOJ**") responded to this trend by adopting the controversial Yates Memo and the subsequent policies. However, they once triggered much criticism and have not yet obtained the aspired results.*

This article takes the view that the agencies are in a better position to allocate their limited resources to corporate FCPA prosecution. First, contrary to common belief, prosecuting companies could achieve great deterring effects whereas prosecuting individuals does not neces-

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[*] Ms. LI Mengshi, Foreign Legal Consultant at Kirkland & Ellis International LLP (Shanghai), holds a Juris Doctor Degree in U.S. law and a Juris Master Degree in Chinese law from Peking University School of Transnational Law. The author owes a debt of gratitude to Professor Matthew C. Stephenson for his invaluable comments and discussions, and tireless guidance and support in the writing of this article. Any remaining shortcomings are solely the author's responsibility. Please address any feedback to mengshiemmali@gmail.com. Please note that this article was submitted in May 2017 and admitted in July the same year. Recently on November 29, 2018 at the American Conference Institute's 35th International Conference on the Foreign Corrupt Practices Act, Deputy Attorney General Rod Rosenstein announced a more flexible approach to issues of individual liability in corporate investigations compared with policies introduced by former Deputy Attorney General Sally Yates in 2015. This largely echoes the author's stance on individual accountability in this article.

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sarily yield the expected results. Second, resolving charges through a settlement regime has multiple benefits for the authorities and companies, such as reducing costs and increasing efficiency, reducing the uncertainty of litigation, and settling guidance for the entire industry. Third, going to court with individuals subjects the agencies to a number of statutory and judicial barriers.

The article proposes that the agencies should, at the current stage, refocus on corporate FCPA enforcement, stress the importance of corporate compliance programs, and use companies as a venue to hold individuals accountable. In the long term, a meaningful increase in FCPA individual prosecutions may be available if the agencies expand the meaning of FCPA individual liability, and have readily available enforcement capacity and intergovernmental cooperation platforms to make it possible.

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I. INTRODUCTION

Companies are fictitious persons that act through natural persons.[1] However, there has been a long-standing outcry that too few accountable individuals are prosecuted for corporate wrongdoings.[2] The criticism exists in almost all corporate crimes, including fraud, anti-trust violations, money laundering, and bribery.[3] It reached a climax after the 2008 financial crisis, where no employee or officer was prosecuted after banks including HSBC settled with the Department.[4] The Department took many efforts to address this problem, including issuing the Yates Memo.

This phenomenon is especially outstanding in the overseas bribery context. The Foreign Corrupt Practices Act ("**FCPA**") was enacted in 1977 to address U.S. companies' outspread corruption overseas revealed after the Watergate scandal.[5] Same as many other corporate crime regulations, the FCPA in its provisional language does not insulate individuals from liability after holding corporations liable, but in real practice only a limited number of individuals are prosecuted for their violations of the FCPA. In 2010, the then-Senator Arlen Spector openly expressed his disappointment that no individual was indicted in the USD1.6 billion Siemens case.[6]

Treating this as a problem of prior importance, scholars and practitioners stress the importance of jailing responsible individuals for FCPA violations, and how it might be the most effective

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[1] N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 493-94 (1909). *See also* U.S. DEP'T OF JUSTICE, U.S. ATTORNEYS' MANUAL §9-28.200 (2008), *available at* http://www.justice.gov/usam/united-states-attorneys-manual.

[2] Brandon L. Garret, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789, 1790 (2015).

[3] RICHARD G. GRUNER, CORPORATE CRIMINAL LIABILITY AND PREVENTION §1.09[2][c] (2016).

[4] BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 253 (2nd ed. 2014).

[5] STEFAN HEISSNER, MANAGING BUSINESS INTEGRITY: PREVENT, DETECT, AND INVESTIGATE WHITE COLLAR CRIME AND CORRUPTION 16 (2015).

[6] Christopher M. Matthews, *Senators Question FCPA Enforcement Policies in Hearing* (Nov. 30, 2010), *available at* http://www.mainjustice.com/ just-anticorruption/2010/11/30/senators-question-fcpa-enforcement-policies-in-hearing, *archived at* http://perma.cc/ENK6-WUVV.

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way to deter perspective offenses. However, if the reason for insufficient prosecutions against individuals is that, comparatively speaking, there are not that many individuals to be prosecuted under the FCPA context at the first place, and taking drastic steps (such as those proposed in the Yates Memo) to prosecute individuals under the current regime would inevitably undermine overall prosecutions, then perhaps the agencies should resist from focusing on individual prosecution at the current stage.

The article brings the attention back to two realities. First, increasing the number of FCPA enforcement actions and imposing large fines on companies is the most effective tool to deter FCPA violations. Prosecuting individuals under the FCPA context has lower priority. Second, only if the current level of prosecutions achieved through the prosecution-through-settlement landscape would be kept intact, which is quite effective compared with the regime before the introduction of Non-Prosecution Agreement ("**NPA**") and Deferred-Prosecution Agreement ("**DPA**"), should the agencies come up with alternative mechanisms to hold individuals liable.

This article first gives an introduction to who are the individuals subject to the FCPA and their potential liability, illustrated with past DOJ and U.S. Securities and Exchange Commission ("**SEC**") enforcement actions and court opinions. It then analyzes the FCPA enforcement trend in the past, and compiles statistics in the past decade to demonstrate how individual prosecutions were both minimal in number and monetary amounts. Third, it looks into the Department's response to an outcry of insufficient prosecution against individuals, in particular the Yates Memo, the DOJ's one-year pilot program (the "**Pilot Program**"), and the revised FCPA Corporate Enforcement Policy. Based on this, it explores into the reasons why few individual prosecutions happened in the past and why overstressing that might actually cause problems. Before conclusion, the article explores into proposals to return to a corporate settlement regime.

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II. INDIVIDUALS SUBJECT TO THE FCPA AND THEIR POTENTIAL LIABILITIES

The FCPA, in its applauded meanwhile frowned-upon nature, has a broad scope.[7] It applies not only to corporations but also to individuals from the United States and overseas through a strict vicarious liability approach.[8] These individuals range from directors and officers high up the corporate ladder,[9] to low-level employees,[10] also including agents, and stockholders. As with corporate wrongdoings, the FCPA prohibits individuals' conducts that are in violation of anti-bribery provisions or accounting provisions. Accordingly, individuals face civil and criminal penalties. This section gives a broad overview of who are the individuals subject to the FCPA and their potential liabilities.

A. Vicarious Liability Under the FCPA

In the United States, corporate liability is based on vicarious liability. If an individual commits a civil or criminal violation, this violation can be attributed to the company. Such an individual could be an employee, a third-party agent, or a consultant.[11]

This same principle applies under the FCPA context. Vicarious liability normally applies if a company authorizes, orders, or controls individuals' conducts that violate the FCPA.[12] As for third parties, even if a third-party individual is not directly subject to the FCPA, a company can be subject to vicarious liability if the company orders, authorizes, or tacitly consents to conducts pro-

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[7] H. LOWELL BROWN, BRIBERY IN INTERNATIONAL COMMERCE § 4:5 (2016).

[8] U.S. DEP'T OF JUSTICE & U.S. SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 12 (2012), *available at* https://www.justice.gov/sites/default/files/criminalfraud/legacy/2015/01/16/guide.pdf.

[9] *In re* Och-Ziff Capital Management Group LLC, OZ Management LP, Daniel S. Och, and Joel M. Frank, Exchange Act Release No. 78989, at 32–35 (Sep. 29, 2016).

[10] *See* SEC v. Bobby J. Elkin, Jr., Baxter J. Myers, Thomas G. Reynolds, and Tommy L. Williams, Civil Action No. 1:10–cv–00661 (D.D.C.) (filed April 28, 2010).

[11] Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984). *See also* Eli Richardson, Ross Booher, and Taylor Phillips, *Is That a Crime? Understanding Risks and Obligations in the Foreign Corrupt Practices Act*, 45, APR TENN. B.J. 14 (2009).

[12] Daniel J. Grimm, *Traversing the Minefield: Joint Ventures and the Foreign Corrupt Practices Act*, 9 VA. L. & BUS. REV. 91, 94 (2014).

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hibited under the FCPA.[13]

In the setting of a corporate FCPA violation, if there is a responsible individual within the entity or affiliated as a third party, there should be a responsible company. However, even if a company is liable, it is not necessarily true that a specific individual would be found liable, especially considering how under U.S. law, an entity's knowledge requirement is distinctly lower than that of a natural person.[14]

B. Anti-bribery Provisions

The FCPA anti-bribery provisions prohibit payment of anything of value to a foreign official intended to gain a business advantage.[15] This applies to those individuals (whether U.S. or foreign nationals) who are shareholders, executives, employees, or agents acting on behalf of issuers[16] or domestic concerns,[17] as well as those who aid and abet or conspire with issuers or domestic concerns.[18] For foreign nationals who do not fall squarely within these categories, the FCPA also applies as long as they engaged in direct or indirect conduct facilitating bribery while within U.S. territories.[19]

Under the FCPA, holding an individual defendant criminally liable requires a showing of willful intent,[20] whereas only proof of corrupt intent is required in proving individual civil liability.[21] "Corruptly" indicates the purpose to wrongly affect the recipient based on the Congress's commentary when promulgating the FCPA.[22] Although the FCPA does not define willful-

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[13] STUART H. DEMING, THE FOREIGN CORRUPT PRACTICES ACT AND THE NEW INTERNATIONAL NORMS 59-74 (2010).

[14] *Id.*

[15] 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), and 78dd-3(a).

[16] 15 U.S.C.A. § 78dd-1(a). An issuer is a public company whose securities are trade on a national securities exchange in the United States, including foreign issuers with exchange-traded American Depository Receipts.

[17] 15 U.S.C. § 78dd-2(a). *See also* United States v. Joel Esquenazi, et al., No. 09-cr-21010-JEM (S.D. Fla.) (filed Dec. 4, 2009).

[18] *Supra* note 8, at 12.

[19] 15 U.S.C. § 78dd-3(a).

[20] 15 U.S.C. §§ 78dd-2(g)(2)(A), 78dd-3(e)(2)(A), and 78ff(c)(2)(A). *Supra* note 8, at 14.

[21] 15 U.S.C. §§ 78ff(c)(2)(A), 78dd-2(g)(2)(A), and 78dd-3(e)(2)(A).

[22] *Supra* note 8, at 14. (The FCPA does not define "corruptly" explicitly, but the Congress gave it the same meaning as in the domestic bribery statute of 18

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ness, courts have understood "willfully" to mean with a bad purpose, namely committed voluntarily and purposefully knowing that his or her conduct was unlawful.[23]

Individual infringers of the anti-bribery provisions are subject to a maximum of five years' imprisonment and a fine capped at USD250,000 per violation.[24]

C. Accounting and Internal Control Provisions

The FCPA's accounting provisions are aimed at strengthening accurate, reliable, and transparent disclosure of public companies.[25] It imposes two requirements on issuers and other companies with stock trades in the over-the-counter market in the US and which file periodic reports with the SEC – to keep books and records "in reasonable details";[26] and to "devise and maintain" adequate and effective internal control mechanisms.[27] Individuals within the company accountable for accounting and internal control violations are determined by their conducts that have directly or indirectly violated the relevant provisions.

Primary violators with knowledge could entail civil and criminal liabilities. The FCPA requires that "[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account."[28] Individuals *controlling* such primary violators could also be held accountable.[29] Under Section 20 of the Securities Exchange Act ("**the Exchange Act**"),[30] any person who "directly or indirectly, controls any person liable under any provision of this title or any rule or regulation thereunder."[31] would be subject to joint and several liability. As developed in

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U.S.C. § 201(b) when drafting the FCPA). *See also* H.R. REP. NO. 95–640, at 7 (1977).

[23] United States v. Kay, 513 F.3d 432, 448 (5th Cir. 2007). *See* United States v. Joel Esquenazi, et al., *supra* note 17.

[24] 15 U.S.C. §§ 78dd–2(g)(2)(A), 78dd–3(e)(2)(A), and 78ff(c)(2)(A). *See also* 18 U.S.C. § 3571(b)(3). *Supra* note 8, at 68.

[25] S. REP. NO. 95–114, at 7 (1977).

[26] 15 U.S.C. §78m(b)(7).

[27] 15 U.S.C. §§ 78m(b)(2)(A), (b)(2)(B).

[28] 15 U.S.C.A. § 78m(b)(5).

[29] BROWN, *supra* note 7, § 4:5.

[30] 15 U.S.C.A. § 78t.

[31] 15 U.S.C.A. § 78t(a).

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case law, controlling person liability requires a minimum showing of power to determine the actual primary violator's conducts, and that person actually exercising such control.[32] Thirdly, individuals who assisted the primary violator could also be criminally liable. Under the aiding and abetting doctrine under Section 20(e) of the Exchange Act, "any person that knowingly provides substantial assistance to another person in violation of […] this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."[33]

Individuals who violate such provisions might be subject to imprisonment of up to 20 years and monetary punishment of up to USD5 million.[34]

III. FCPA ENFORCEMENT TREND IN THE PAST

In the first two to three decades following its promulgation in 1977, the FCPA was only a façade when the country was witnessing next to zero FCPA enforcements.[35] Of the very few, a large proportion of them involved individual enforcements. Before 2004, about 83% of FCPA enforcement actions resulted in individual prosecutions.[36] The Department first introduced the use of DPA to resolve FCPA charges in 2004, and this ushered in an unprecedented settlement regime. Coupled with more advanced investigative techniques and evidence gathering capacities, the agencies witnessed a surge of FCPA enforcement actions following this change.[37] In the past decade, individual prosecu-

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[32] Metge v. Baehler, 762 F.2d 621, (8th Cir. 1985).

[33] 15 U.S.C.A. § 78t(e).

[34] 15 U.S.C. §78ff(a).

[35] Joseph W. Yockey, *FCPA Settlement, Internal Strife, and the "Culture of Compliance"*, 2012 WIS. L. REV. 689, 692 (2012).

[36] Mike Koehler, *Measuring the impact of Non-Prosecution and Deferred Prosecution Agreements on Foreign Corrupt Practices Act Enforcement*, 49 U.C. DAVIS LAW REVIEW 497, 541 (2015). *See also Out of Court, Out of Mind: Do Deferred Prosecution Agreements and Corporate Settlements Fail to Deter Overseas Corruption* (Mar. 10, 2016), CORRUPTION WATCH, *available at* http://www.cw-uk.org/wp-content/uploads/2016/03/Corruption-Watch-Out-of-Court-Out-of-Mind.pdf.

[37] OECD, *Report on the Application of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 2009 Revised Recommendation on Combating Bribery in International Business Transactions* 11 (2010) at 3. *Supra* note 35, at 697.

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tions contrast sharply with corporate prosecutions in terms of both the numbers of cases and the sanction amount.

A. Low Proportion of DOJ Enforcement Actions Against Individuals

From 2007 to 2017, the Department has concluded enforcement actions against 131 individuals. A majority were charged in four cases, namely the Africa Sting case (22 individuals), the Terra Telecommunications case (9 individuals), the Siemens case (8 individuals), and the Control Components case (8 individuals). 45 individuals received jail sentencing. Monetary punishment imposed on individuals were in a total amount of USD250 million, constituting only 3.87% of the total amount by the DOJ in the past 11 years.

FIGURE 1: INDIVIDUALS PROSECUTED IN DOJ ENFORCEMENT ACTIONS

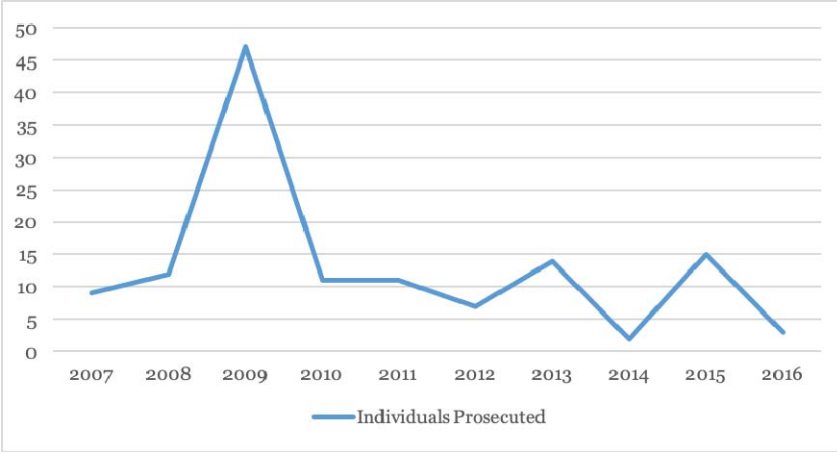

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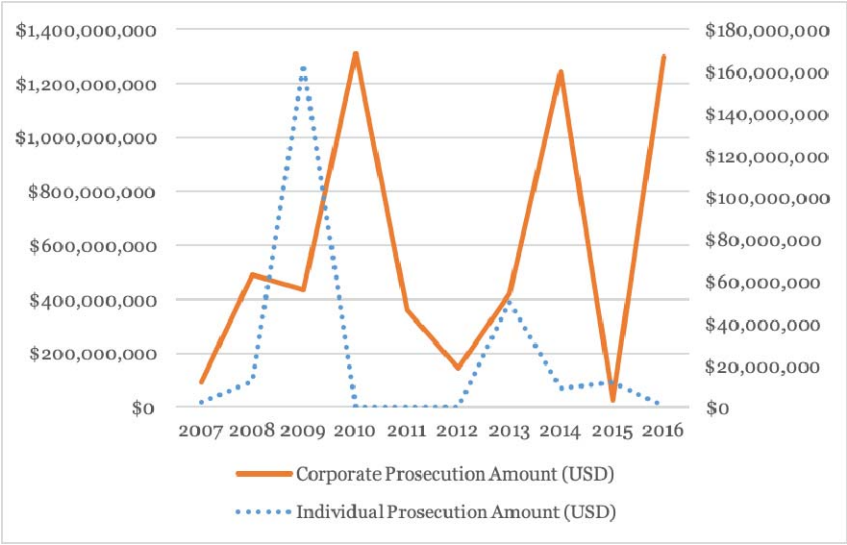
FIGURE 2: DOJ INDIVIDUAL AND CORPORATE PROSECUTIONS MONETARY SANCTIONS



B. Low Proportion of SEC Enforcement Actions Against Individuals

The SEC only sanctioned 50 individuals from 2007 to 2017.[38] Out of the overall fines imposed, only 0.27% of the prosecution amount comes from individuals. Of the top 10 SEC enforcement actions by largest monetary sanction, merely three involve individual prosecutions.[39]

[38] MIKE KOEHLER, THE FOREIGN CORRUPT PRACTICES ACT IN A NEW ERA 206 (2014).

[39] *See* SEC v. Halliburton Company and KBR, Inc., No. 09-cv-00399 (S.D. Tex.) (filed Jan. 9, 2009); SEC v. Siemens Aktiengesellschaft, No. 08-cv-02167 (D.D.C.) (filed Dec. 12, 2008); *Supra* note 9; and SEC v. Michael L. Cohen and Vanya Baros, Civil Action No. 17-cv-00430 (E.D.N.Y.) (filed Jan. 26, 2017).

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FIGURE 3: INDIVIDUALS PROSECUTED IN SEC ENFORCEMENT ACTIONS

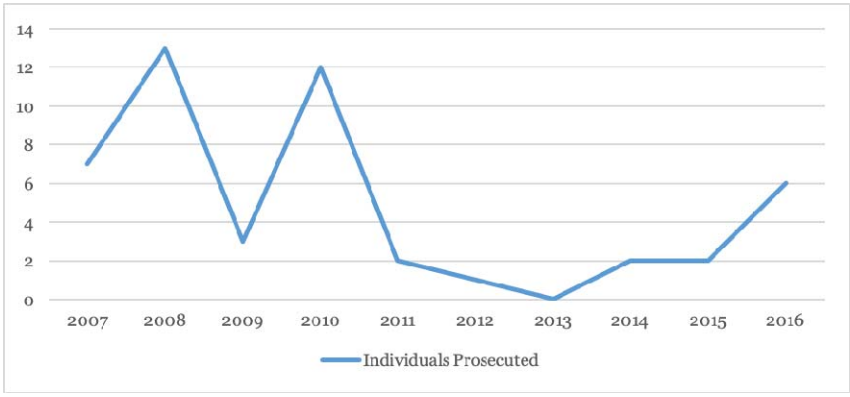
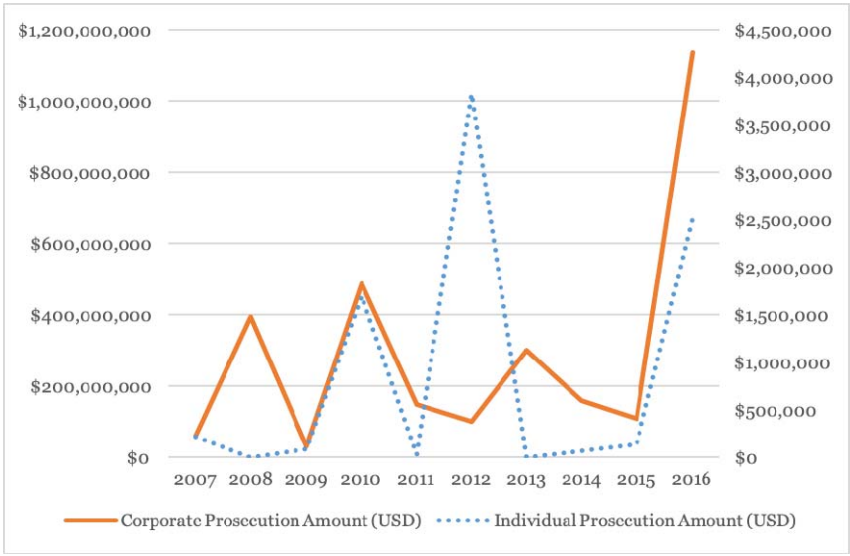


FIGURE 4: SEC INDIVIDUAL AND CORPORATE PROSECUTIONS MONETARY SANCTIONS



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IV. THE DOJ'S RESPONSE TO THE TREND OVER INDIVIDUAL PROSECUTION

The trend of comparatively less individual prosecutions stirred up much criticism in the past. In response to such criticisms, the DOJ and the SEC have more than once expressed their view that to have a credible deterring effect, people must go to jail, and individuals must be prosecuted appropriately.[40] The most drastic step was taken, however, when the Department released a memorandum titled "Individual Accountability for Corporate Wrongdoing", known as the Yates Memo, delivered by Deputy Attorney General Sally Q. Yates on September 9, 2015. The Yates Memo drastically shifts the focus of prosecution of corporate wrongdoings onto culpable individuals. All principles set out in the Yates Memo are applicable to the FCPA, which is announced in the Pilot Program.[41] In November 2017, the DOJ announced the new FCPA Corporate Enforcement Policy based on the Pilot Program.[42]

The Yates Memo introduces 6 points that could be categorized into the following two groups:[43] First, companies must provide *everything* about *every* individual involved in corporate misconduct in order to receive *any* cooperation credit from the DOJ, and they may not use corporate resolutions to shield individuals from criminal or civil liabilities. Second, the DOJ must plan out and start a dual-track investigation on individuals and companies at the outset of an investigation, facilitate communications between criminal and civil attorneys, and prosecute individ-

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[40] Roger M. Witten, Kimberly A. Parker, Jay Holtmeier, and Lillian H. Potter, *The Increased Prosecution of Individuals Under the FCPA: Trends and Implications*, BLOOMBERG LAW REPORTS (2009), *available at* https://www.wilmerhale.com/en/insights/publications/the-increased-prosecution-of-individuals-under-the-fcpa-trends-and-implications-january-7-2010.

[41] U.S. DEP'T OF JUSTICE, THE FRAUD SECTION'S FOREIGN CORRUPT PRACTICES ACT ENFORCEMENT PLAN AND GUIDANCE (2016), *available at* https://www.justice.gov/opa/file/838386/download. *See also* WILLIAM M. HANNAY, CORPORATE COMPLIANCE SERIES: DESIGNING AND IMPLEMENTING AN EFFECTIVE FCPA AND ANTI-BRIBERY COMPLIANCE PROGRAM § 1:21 (2016).

[42] Deputy Attorney General Rod J. Rosenstein, *The FCPA Corporate Enforcement Policy* (Nov. 29, 2017), *available at* https://www.justice.gov/criminal-fraud/file/838416/download.

[43] Memorandum from Sally Quillian Yates, *Individual Accountability for Corporate Wrongdoing* 1 (Sept. 9, 2015), *available at* http://www.justice.gov/dag/file/769036/download/.

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uals even if that means collecting a lesser amount of fines since the individual defendant's ability to pay is limited.

The Pilot Program grasped the tenet of the Yates Memo. It makes it FCPA-specific, and informs companies and executives of their basic positions. It uses cooperation credit as a tool to encourage voluntarily self-disclose involving individuals' misconducts in FCPA-related wrongdoings, in order to promote greater individual accountability.[44] It states that cooperating companies must timely disclose all facts relevant to company's individuals' involvements to meet the threshold cooperation standard. The final FCPA Corporate Enforcement Policy marked several changes. Above all, if a company provides sufficient voluntary self-disclosure, there will be a presumption that the DOJ will resolve the matter through a declination.[45]

V. PROBLEMS WITH OVERSTRESSING INDIVIDUAL PROSECUTION

Had the Department been correct that individual prosecution is the most powerful tool to deter overseas bribery overall, we should have anticipated a surge in the number of cases against individuals with the agencies' past efforts (especially after the Yates Memo). With that, we could have witnessed a decrease in corporate prosecutions since there should supposedly be less companies daring to commit such offenses.

However, none of these has happened. Referring to Figure 2 and Figure 4, we could notice that in the past over 10 years, with the agencies' increased efforts in bringing up individual prosecution level, the enforcement actions against individuals have stayed at the same low level. Moreover, there was no clear correlation (let alone causation) between individual prosecution and corporate prosecution.

One could argue that maybe the agencies' past efforts, including the Yates Memo, have not been the most effective nudge towards more individual liability. For instance, the DOJ seems to be still focusing on companies not individuals even after the most dramatic Yates Memo. The recent prosecution against Vimpel-

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[44] *Supra* note 41, at 6–7.

[45] *Deputy Attorney General Rod J. Rosenstein, the FCPA Corporate Enforcement Policy* (Nov. 29, 2017), *available at* https://www.justice.gov/ criminal-fraud/file/838416/download.

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Com imposed the third largest monetary sanctions in FCPA enforcement history. Even though that case attracted great attention, even though that case was after the Yates Memo, and even though that case involved Vimpelcom's senior executives, the DOJ made no mention of prosecution against individuals in the final resolution.[46] We need to adopt more dramatic approaches, such as abandoning the DPA and NPA settlement regime in its entirety, thus ensure that the agencies cannot rely on settlements to avoid waging investigations and prosecution against both individuals and companies.

However, this article believes that the past efforts were in vain and failed to achieve the expected results because FCPA infringements are based on much more complex and concerted corporate decision-making as opposed to one rogue employee being the controlling impetus. Under the current regime, few individuals can be legally accountable at the first place, and with the agencies' limited resources, substantially redirecting them to go after individuals is a mistaken step.

A. Wrong Evaluation of the Deterring Effects over Companies and Individuals

1. Moral Justification of Corporate Prosecution

Many critics of corporate criminal punishment borrows from John Coffee's "No Soul to Damn: No Body to Kick"[47] and argue that, morally speaking, there is little point in penalizing corporations.[48] Culpable individuals are the only ones who have the mental capacity to decide what actions to take and the only ones who could feel deterred. Moreover, prosecuting companies is imposing unwarranted moral obligations on innocent third

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[46] *See* United States v. VimpelCom Ltd., et al., No. 16-cr-00137 (S.D.N.Y.) (filed Feb. 18, 2016).

[47] John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981).

[48] *See* David M. Uhlmann, *The Pendulum Swings: Reconsidering Corporate Criminal Prosecution*, 49 U.C. DAVIS L. REV. 1235 (2016). *See also* Albert W. Alschuler, *Ancient Law and the Punishment of Corporations: Of Frankpledge and Deodand*, 71 B.U. L. REV. 307, 311-12 (1991). *See also* John T. Byam, *The Economic Inefficiency of Corporate Criminal Liability*, 73 J. CRIM. L. & CRIMINOLOGY 582, 583-85 (1982).

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parties (including shareholders and leadership of the corporations).

This is a rather simplified interpretation of companies' decision-making process, and a misrepresentation of vicarious liability. Although company itself cannot fathom morality and righteousness the way an individual does, the internal decision-making mechanism of a company allows it to act intentionally as a human being does. Companies can be moral agents and make business decisions guided by ethical standards. That is why different corporations, like different individuals, have distinct corporate cultures. Some companies uphold compliance cultures in conducting businesses, while others might rather sacrifice its reputation for commercial advantages.

With regards to the second argument, such shareholders and managers are not innocent third parties. They are the ones enjoying the proceeds of corruption through the corporate structure. The individual actors are the hands and limbs of the companies, and they act on behalf of and under the auspices of the companies. Individuals bribed foreign officials to bring in more businesses to the company and therefore raise the shareholders' profits. It would be morally righteous and fair for shareholders to bear the costs of reaping illegal profits.

2. Corporate Prosecution more than a Cost of Doing Business

There is a fear that when companies enter into DPAs and NPAs with the enforcement agencies, they do that out of fear of risks, not genuine acknowledgement of the wrongdoings. Companies would agree to settlement amounts to bury facts, wash off guilt, and buy-off charges against corporate officials. By contrast, plea agreements pursued by enforcement agencies, which also enables concurrent prosecution against individuals, requires investigations of higher quality based on greater evidence.[49]

However, companies as collective rational actors would treat fines as a warning of prohibition.[50] They would take into account the threat of criminal sanctions, regulatory punishments,

[49] *Supra* note 38, at 204.

[50] Larry E. Ribstein, *Agents Prosecuting Agents*, 7 J.L. ECON. & POL'Y 617 (2010).

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and imponderable reputational costs even when only facing potential FCPA investigations.[51] Instead of "paying the bills" as they come in and internalizing such costs, companies do try their best to prevent such violations from occurring.

A sign of companies treating prosecutions seriously is how they are investing heavily into building corporate compliance programs. This in turn would build a culture of ethics and compliance within the company, making sure that the deterring effect on companies would trickle down to each individual actor within the corporate structure. In some instances, the costs of building such compliance programs far exceed the fines. For instance, Wal-Mart, an industry-leader in FCPA compliance practices especially after the 2012 bribery scandal in Mexico,[52] invested more than USD141 million in global ethics and compliance systems since 2013.[53] It invested approximately USD120 million in 2017 alone on FCPA-related expenses.[54]

3. Individual Prosecution less Deterrence than Expected

Individuals are not necessarily deterred by the mere chance of going to jail. Studies have shown that the threat of formal sanctions plays a minor role in individuals' decision making.[55] The executives' inherent moral standards and how the corporate culture treats such conducts (whether they foster or discourage such conducts) play a more important role. Assuming individuals are rational actors and do take into consideration formal sanctions that may ensue, they doubt if their conducts alone would cause formal sanctions considering the low proportion of successful

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[51] THE OXFORD HANDBOOK OF WHITE COLLAR CRIME 623 (SHANNA R. VAN SLYKE, MICHAEL L. BENSON, AND FRANCIS T. CULLEN ed., 2016).

[52] David Barstow, "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle," NEW YORK TIMES (April 21, 2012), *available at* http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?pagewanted=all&_r=0.

[53] Reflecting on What We've Built: Walmart's Global Ethics & Compliance Program (2017), *available at* http://corporate.walmart.com/global-responsibility/global-compliance-program-report-on-fiscal-year-2017.

[54] Wal-Mart Q4 FY16 Financial presentation to accompany management transcript, February 18, 2016, *available at* http://s2.q4cdn.com/056532643/files/doc_financials/2016/Q4/Q4-FY16-earnings-presentation-final.pdf.

[55] Smith, N. Craig, Sally S. Simpson, and Huang Chun- Yao, *Why Managers Fail to Do the Right Thing: An Empirical Study of Unethical and Illegal Conduct*, BUSINESS ETHICS QUARTERLY 17: 633– 67 (2007).

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convictions in the past, possibly because they only constitute a part of a global act, and possibly because of all the other investigative and statutory burdens that would be further explored in this article. Moreover, individuals are more attracted by the fast payoff in a direct reward, a promotion, or other career advancements regardless of the potential costs.[56]

B. The Advantages of FCPA Corporate Settlements

Radical proponents of individual prosecution argue that the Department should decrease settlements with corporations and press for more individual prosecutions. This is a dangerous approach that might seriously undermine the past enforcement achievements.

1. What Is a FCPA Settlement

The use of settlements is the most pervasive mechanism to resolve charges under U.S. criminal law. The FCPA is not an exception. Apart from the traditional plea agreements which in effect lead to convictions,[57] under a DPA, the Department promises to dismiss charges after approximately three years if a company timely and voluntarily disclosure wrongdoing and willingly cooperate in the investigation. This is supposedly subject to court review. Under a NPA, no court case needs to be filed and regulators could file charges but could also refrain from doing so if the company complies with the agreed terms. Where no criminal charge is pressed but only civil action pursued, the SEC also frequently adopts DPAs and NPAs coupled with cooperation agreements to resolve disputes.[58] Approximately 90% defendants settled with the SEC and 75% settled with the DOJ.[59]

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[56] SHOVER, NEAL, AND ANDY HOCHSTETLER, CHOOSING WHITE-COLLAR CRIME (2006).

[57] World Bank/StAR, Left Out of The Bargain: Settlements in Foreign Bribery Cases and Implications for Asset Recovery 32 (27 November 2013) *available at* https://star.worldbank.org/star/publication/left-out-bargain-settlements-foreign-bribery-cases-and-implications-asset-recovery.

[58] Corruption Watch, *Out of Court, Out of Mind: Do Deferred Prosecution Agreements and Corporate Settlements Fail to Deter Overseas Corruption* (March 2016), *available at* http://www.cw-uk.org/wp-content/uploads/2016/03/Corruption-Watch-Out-of-Court-Out-of-Mind.pdf. *See also* MIKE KOEHLER, THE FOREIGN CORRUPT PRACTICES ACT IN A NEW ERA 206 (2014).

[59] *Available at* http://fcpa.stanford.edu/statistics-keys.html.

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Cooperation credit plays an important role in enforcement authorities' decisions as to whether to settle as an alternative to trial. Authorities designed the cooperative enforcement model to encourage companies to engage in the battle against bribery. Companies could earn cooperation credit when they voluntarily self-report and cooperate with investigations.[60] Prosecutors are instructed to consider eight factors in determining whether to bring charges against corporations for corporate wrongdoing. One factor is "[t]he corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents[.]"[61]

2. The Merits of Settlements

(a) Cost-effective for the Agencies to Investigate and Resolve

FCPA settlements benefit both the public and the private sectors. For the agencies, settlement is a cost-effective and viable means to ward off companies against corruption, and to make sure that the agencies have enough money to keep finding out more corrupt businesses and settle with them. Most FCPA violations happen overseas. Although we have the OECD and other regional cooperation agreements, it is rare for other jurisdictions to assist with the Department or the FBI to investigate into companies' misconducts. The exception is if the other jurisdiction is also charging against such companies overseas. This, however,

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[60] Sharon Oded, *Coughing Up Executives or Rolling the Dice?: Individual Accountability for Corporate Corruption*, 35 YALE L. & POL'Y REV. 49 (2016).

[61] Memorandum from Deputy Att'y Gen. Eric Holder, Bringing Criminal Charges Against Corporations (June 16, 1999), *available at* http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/charging-corps.pdf. Memorandum from Deputy Att'y Gen. Larry D. Thompson, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), *available at* http://www.americanbar.org/content/dam/aba/ migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp.authcheckdam.pdf. Memorandum from Deputy Att'y Gen. Paul J. McNulty, Principles of Federal Prosecution of Business Organizations (Dec. 12, 2006), *available at* http://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty_memo.pdf. Memorandum from Deputy Att'y Gen. Mark Filip, Principles of Federal Prosecution of Business Organizations (Aug. 28, 2008), *available at* http://www.justice.gov/sites/default/files/dag/legacy/2008/11/03/ dag-memo-08282008.pdf [*available at* http://perma.cc/XQS4-BE7Q].

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does not happen frequently. In most occasions, enforcers have to go overseas and collect evidences themselves. Coupled with the reality of how a legal entity is a complex and well-knitted structure to "bury up facts", it is almost impossible considering the limited time and resources the agencies could impart to FCPA enforcements.

(b) Less Antagonism and Uncertainty for Companies

From the companies' perspective, they are willing to turn themselves in and help the agencies in finding against themselves because negotiating with the DOJ is not always adversarial and unpleasant. The DOJ would often look at the totality of circumstances when deciding mitigating factors, and give reasonable offers. Companies no longer need to face the irreparable collateral consequences from an indictment such as reputational damages and could avoid the uncertainties of litigation.

(c) Guidance for the Industry

A settlement regime could also guide future companies on the appropriate way to manage business overseas. DOJ enforcement agencies are more experienced than courts with these issues and they would tailor their actions to each individual case after thorough negotiation and impose sanctions which are proportional to the offenses. For example, the DOJ-issued "Resource Guide to the U.S. Foreign Corrupt Practices Act" already provides guidance on corporate conduct.

C. The Downside of Going to Court with Individuals

Since settlements through a DPA and NPA regime have many advantages, one cannot help but wonder why agencies do not settle with individuals as they do with companies. In reality, there are many FCPA enforcement precedents but not many FCPA court opinions.[62] Of the handful few, only one case that went to trial involves a corporation,[63] and all others are stirred up by

[62] Mike Koehler, *Big, Bold, and Bizarre: The Foreign Corrupt Practices Act Enters a New Era*, 43 UNI. OF TOLEDO L. REV. 99 (2011).

[63] United States v. Harris Corp., No. 90-cr-0456 (N.D. Cal. 1990).

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individuals.[64]

Individuals are prone to go to trial on FCPA charges possibly because compared with companies, they tend to earn sympathy before a jury trial or a judge and have a better winning chance.[65] Moreover, individuals fear time in jail, and dread subsequent charges in other jurisdictions based on the same alleged conducts and subsequent derivative actions. In the Siemens' case, executives were not only facing million-dollar penalties at home, but also charged in many other jurisdictions, including by the Argentinian government and the German government.[66] Individuals would be motivated to consider trying the case as a response strategy.[67]

In tackling individuals, the regulators must be prepared to go to court, an adversarial, costly, time-consuming, and unpredictable process. FCPA agencies would run the risk of courts deciding in favor of individuals and restrict the applicable scope of the FCPA. Now that companies are incentivized against self-disclosure, the Department and FBI might need to spend additional human resources and money on investigations overseas.

1. Statutory Barriers and Risks of Judicial Second-guessing

There are certain elements of the law that make the agencies impractical to satisfy in order to establish in court that an individual has violated the FCPA. These difficulties include lack of personal jurisdiction over certain individuals, passing statutes of limitation, and wrongful intent. Although the same problems exist in corporate prosecutions, they would seldom become a

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[64] For instance, the ones against individuals include: United States v. Kay, 513 F.3d 432 (5th Cir. 2007); United States v. Kozeny, 667 F.3d 122 (2d Cir. 2011); United States v. Liebo, 923 F.2d 1308 (8th Cir. 1991); and United States v. Castle, 925 F.2d 831 (5th Cir. 1991).

[65] MIKE KOEHLER, THE FOREIGN CORRUPT PRACTICES ACT IN A NEW ERA 206 (2014).

[66] Maria Armental, *Former Siemens Executive Pleads Guilty to Argentina Bribery Charges*, WALL ST. J. (Sep. 30, 2015), *available at* https://www.wsj.com/articles/ former-siemens-executive-pleads-guilty-to-argentina-bribery-charges-1443649567. Grant McCool, *Siemens executives charged with bribery*, REUTERS (Dec 13, 2011), *available at* http://www.reuters.com/article/us-siemens-argentina-idUSTRE7BC18J20111213.

[67] *Former Siemens Executives Receive Record-Breaking Individual FCPA Fines in Default Judgment*, 3 THE FCPA REPORT, 4 (2014).

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concern mainly because companies would waive such defenses in exchange for a friendly settlement with the agencies.

(a) Lack of Personal Jurisdiction over Foreign Primary Violators

Most FCPA primary violators are individuals who have never entered into the U.S. territory. They are the ones who often directly bribe foreign officials overseas and manipulate the financial records reported to the mother company. FCPA court case against a foreign national requires that the court have both subject matter jurisdiction and personal jurisdiction.[68] However, establishing personal jurisdiction over these individuals can be challenging. Many of the individual infringers are foreign nationals outside the U.S., as many are employees of the foreign subsidiary rather than the parent issuer.[69]

Under Section 27 of the Exchange Act, the court could exercise personal jurisdiction over defendants subject to the Fifth Amendment Due Process limitation."[70] Pursuant to *International Shoe v. Washington*, due process requires that defendant outside the U.S. must "have certain minimum contacts with it such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice."[71] A two-prong test is extracted from this, namely the minimum-contacts analysis and a reasonableness inquiry.[72] However, two court opinions in 2013 from the Southern District of New York illustrates how divergent courts could be on its interpretation.

In *SEC v. Straub*,[73] the court exercised personal jurisdiction over the defendant, a Hungarian citizen, because the defendant made written certifications to the accountants of Magyar, the Hungarian telecommunications company that engaged in a

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[68] Blackmer v. U.S., 284 U.S. 421, 438 (1932).

[69] Andrew Ceresney, *Remarks at 31st International Conference on the Foreign Corrupt Practices Act* (Nov. 19, 2014), *available at* https://www.sec.gov/News/ Speech/Detail/Speech/1370543493598.

[70] 15 U.S. Code § 78aa. *See also* Securities and Exchange Commission v. Unifund SAL, 910 F.2d 1028, 1033 (2d Cir.1990).

[71] International Shoe v. Washington, 326 U.S. 310, 316 (1945).

[72] King County, Wash. v. IKB Deutsche Industriebank AG, 712 F.Supp.2d 104, 111 (S.D.N.Y. 2010).

[73] Securities and Exchange Commission v. Straub, No. 11 Civ. 9645, 2013 WL 466600 (S.D.N.Y. Feb. 8, 2013).

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scheme to bribe Macedonian officials. This action was alleged to be authorization of bribes and approval of falsified SEC filings directly.

In the *Sharef* case, Judge Scheindlin held that it was not reasonable for the court to exercise personal jurisdiction over Herbert Steffen, a German citizen who was the CEO of Siemens Argentina. The court reasoned that not to mention that SEC failed to establish that Steffen was not allegedly involved in the falsification of SEC filings in furtherance of cover ups, even if it were, participation in the cover-up of a bribe is not enough to confer personal jurisdiction on a defendant who did not act in the United States. Steffen's involvement in the U.S. was "tangential at best," thus his "actions were far too attenuated from the resulting harm" to establish the minimum contacts.[74]

The two contrary cases reflect on how the same court might yield confusing opinions on when could the U.S. judicial system exert personal jurisdiction over foreign nationals.[75] It is possible to witness a proliferation of cases in which different courts adopt different tests to evaluate whether "minimum contact" has been satisfied. This uncertainty does increase the costs and risks for the agencies to pursue an enforcement action against individuals from other jurisdictions.

(b) Expiring Statute of Limitation

Another technical concern is that the statute of limitation might expire before the agencies could build a case against the potential wrongdoers.[76] Substantive FCPA offenses are subject to a five-year statute of limitations[77] which requires that charges must be brought within five years of the activity fulfilling the

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[74] Securities and Exchange Commission v. Sharef et al., No. 11 Civ. 9073, 2013 WL 603135 (S.D.N.Y. Feb. 19, 2013).

[75] Claudius O. Sokenu, Esq., and Arthur Luk, Esq., Arnold & Porter, *Personal Jurisdiction over Foreign Nationals in Foreign Bribery Cases Curtailed*, 23 WESTLAW JOURNAL PROFESSIONAL LIABILITY 1 (2013).

[76] Andrew Ceresney, *Keynote Address at the International Conference on the Foreign Corrupt Practices Act* (November 19, 2013), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370540392284. *See also* Andrew Ceresney, *ACI's 32nd FCPA Conference Keynote Address* (November 17, 2015), *available at* https://www.sec.gov/news/speech/ceresney-fcpa-keynote-11-17-15.html.

[77] 18 U.S.C. §3282(a).

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relevant elements of the bribery offense. The statute kicks off immediately after the last offense. In June 2017, the Supreme Court held that the five-year statute of limitations[78] applies to SEC claims for disgorgement.[79] Although this was not a FCPA case, it might greatly impact FCPA claims, because of its resource-intensive and time-consuming nature.

This poses an even harsher problem for prosecution against individuals. Unlike companies, individuals are less willing to waive the statute of limitations defense. Companies wish to avoid endless investigations and trial, want to settle with the enforcement agencies, and merit full cooperation.[80] As a showcase of cooperativeness, companies would agree to give up the statute of limitation defense even if they have a good chance of raising it. For instance, the agencies' actions against Total S.A. were initiated in 2003 but they were not filed until 2013.[81] Litigious individuals would seldom give up such a defense in exchange for a costly cooperation with the agencies.

(c) Difficulty in Proving Intent in Court

Mens rea is often the most difficult component in corporate crime cases to prove. The FCPA is no exception, and the problem is more outstanding in an individual defendant context. Two hurdles exist in proving an individual has satisfied the intent requirement to trigger FCPA prosecutions: lack of a lucid and guiding statutory or case-law definition of wrongful intent, and near impossibility in factually proving such intent.

The FCPA in its statutory language require the enforcers to establish a *corrupt intent* in order to exert minimum civil liabilities on individuals, and *willful intent* is required to impose criminal liabilities. However, both terms are not defined in the statute.

When drafting the FCPA, the Congress indicated "corrupt-

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[78] 28 U.S.C. § 2462.

[79] Kokesh v. United States, No. 16–529 (581 U.S. __, 2017) (Kokesh was found in violation of securities laws by concealing the misappropriation of USD34.9 million from business development companies).

[80] Mike Koehler, *A Foreign Corrupt Practices Act Narrative*, 22 MICH. ST. INT'L. L. REV. 961 (2014).

[81] *In re* Total, S.A., Exchange Act Release No. 3–15338 (May 29, 2013).

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ly" to mean the intent to wrongly influence the recipient.[82] Absent such guiding commentary, the courts' interpretation of willfulness muddies the water and further confuses willfulness with corruptness. In United States v. Kay,[83] the court recognized that by possessing a *willful intent*, the individual "need not have known of the specific statute, but rather he must have acted with the knowledge that he was doing a 'bad' act under the general rules of law." United States v. Kozeny[84] followed this line of argument and added that "ignorance of the law is no excuse."

Proving willful intent in establishing criminal liability does not impose a higher standard on the Department as proving corrupt intent in establishing civil liability. Courts therefore disregard the statute's explicit distinction between two different terms,[85] conflates *corrupt* and *willful*, and makes it harder for the law enforcement to determine when should an individual be criminally liable when a civil sanction seems to suffice.

Moreover, it is challenging to establish factual intent. Most FCPA violations, as with all corporate wrongdoings,[86] are "team sports." They are committed with the collective knowledge of multiple low-ranking employees and those in managerial position.[87] Corporations compartmentalize knowledge and subdivide duties. It will be difficult to point to one individual and label that individual as responsible for the company's wrongdoing.

For instance, it would be difficult to conclude that directors of a U.S. mother company letting its subsidiaries to expand into countries like China and allowing them to blend in, operate like and compete with other local businesses, and make more profits would be in possession of a bad purpose knowing that the conduct was unlawful. However, these low-ranking employees from

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[82] U.S. DEP'T OF JUSTICE & U.S. SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 14 (2012), *available at* https://www.justice.gov/sites/default/files/criminalfraud/legacy/2015/01/16/guide.pdf.

[83] United States v. Kay, 513 F.3d 432, 448 (5th Cir. 2007).

[84] United States v. Kozeny, 493 F. Supp. 2d 693 (S.D.N.Y. 2007).

[85] United States v. Kay, 5 13 F.3d 432 (5th Cir. 2007).

[86] Richard G. Gruner, CORPORATE CRIMINAL LIABILITY AND PREVENTION §1.09[2][c] (2016).

[87] Brandon L. Garrett, TOO BIG TO JAIL 88 (2014). Sridhar Ramamoorti, *The Psychology and Sociology of Fraud,* 23 ISSUES IN ACCOUNTING EDUCATION 529 (2008).

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foreign jurisdictions might interpret this to be a tacit consent for them to donate to a charitable organization designated by a Chinese official in order to be condoned in Chinese administrative decisions as in the Nu Skin case,[88] or to initiate a sons-and-daughters program to recruit relatives from Chinese officials in exchange for their preferential treatment.[89]

Further, SEC and DOJ enforcement actions have ripple effects on individuals within companies in other civil litigations. Board and executives of companies that have violated the FCPA might be sued by the company for breach of fiduciary duties, or by shareholders in derivative actions. However, the fact that individuals are frequently sued but rarely ruled against in these actions might be another concern why enforcement agencies are reluctant to go after them.

For instance, Louis Berger Group sued its former executive Richard J. Hirsch for breach of fiduciary duties in authorizing improper payments to foreign officials.[90] However, absent showing of particularized facts proving that the defendants knew the problems and failed to take action, the board-friendly business judgment rule shield the board and its members from liability. On a similar vein, the administrative might not want to deviate that much from the judiciary.

2. Significant Investigative Burden

It has been mentioned that one of the advantages of settling with a company is the distress in investigating company violations. One of the similar setbacks in litigating with an individual is the cumbersomeness in bearing the burden of proof, which could be many times worse than investigating corporate misconducts.

The regulators are facing both a colossal fictitious person with loopholes in the management structure to make investigative breakthroughs, and individual defendants who is determined to

[88] *In re* Nu Skin Enterprises, Inc., Exchange Act Release No. 3–17556 (Sep. 20, 2016).

[89] *In re* JPMorgan Chase & Co., Exchange Act Release No. 3–17684 (Nov. 17, 2016).

[90] The Louis Berger Group Inc. and Berger Group Holdings Inc. v. Richard J. Hirsch, No. L–1293–16, the Superior Court of New Jersey (June 9, 2016).

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fight tooth and nail for his or her freedom and good name.[91] An example was when the SEC dropped allegations against Deutsche Telekom executives. The agencies felt incapable of pursuing such a complex case, as it involves six countries, hundreds of witnesses speaking more than twelve languages, and 26 million documents to review.[92] As another example, the Department requested the court to dismiss indictments against individuals in the "African Sting" case.[93] Judge Leon dismissed the case, expressed concern over such investigations, and lamented that this long and costly ordeal should be "a learning experience for the Department and the FBI as they regroup to investigate and prosecute FCPA cases against individuals in the future."[94] Cases as these show how expensive and ineffective it could be for the agencies to investigate and pursue cases against individuals on their own.

VI. PROPOSALS

A. Return to a Corporate Settlement Regime in the Short Term

The agencies are advised to allocate their limited resources to where is needed the most – corporate prosecutions. As illustrated, focusing on individual prosecution at the moment would be throwing money down the drain.

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[91] Joseph W. Yockey, *FCPA Settlement, Internal Strife, and the "Culture of Compliance"*, 2012 WIS. L. REV. 689, 692 (2012). *See also* FRANK SHEEDER, COMPLIANCE & ETHICS PROFESSIONAL 75 (2015). *See also* Andrew Ceresney, *ACI's 32nd FCPA Conference Keynote Address* (November 17, 2015), *available at* https://www.sec.gov/news/speech/ceresney-fcpa-keynote-11-17-15.html.

[92] Joel Schectman, *SEC Drops Montenegro Bribe Allegations Against Executives*, WALL ST. J. (Mar 10, 2014), *available at* http://blogs.wsj.com/riskandcompliance/ 2014/03/10/sec-drops-montenegro-bribe-allegations-against-executives/. *See also* Michael Himmel and Steven Llanes, *Should an Individual Defendant Go to Trial on FCPA Charges? Five Important Considerations*, 3 The FCPA Report 11 (2014).

[93] It is a case in which the Department indicted 22 executives and employees of companies in the military and law enforcement products industry for conspiring to bribe foreign officials to obtain businesses in January 2010. See Paul T. Friedman and Demme Doufekias, *Most Severe Setback to DOJ Thus Far in FCPA Prosecutions: Judge Dismisses All Charges In Africa Sting Case* (February 27, 2012), *available at* http://cn.lexology.com/library/ detail.aspx?g=1c58c60f-0a6b-44d0-8bb9-700ee1042b5e.

[94] United States v. Amaro Goncalves, John M. Mushriqui, Jeana Mushriqui, Ofer Paz, Israel Weisler, Michael Sacks, and Marc Morales, No. 09-cr-335, (D.D.C.) (filed on December 11, 2009). (Transcript of Status Conference before the Honorable Judge Richard J. Leon on February 21, 2012). United States v. VimpelCom Ltd., et al., No. 16-cr-137 (S.D.N.Y. Feb. 18, 2016).

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1. Focus Current Investigative Resources on Corporations

The enforcement agencies should redirect the efforts from individual prosecution to companies, and impose harsher punishments on corporate groups. Although FCPA sanctions should not be taken as a cost of doing business, its deterring effects largely depend on the amount of fines imposed and the likelihood for this to happen. Therefore, one suggestion is for the agencies to concentrate their efforts on FCPA corporate enforcement and enforce at a greater pace and impose higher conditions for settlements.

2. Promote a Culture of Compliance Within Companies

As opposed to the confrontational approach adopted in the Yates Memo and the Pilot Program, the enforcement agencies are advised to incentivize companies to build a culture of compliance and promote individual accountability within the corporate structure and reward companies that implement comprehensive internal compliance programs to prevent employees from committing FCPA violations. The new FCPA Corporate Enforcement Policy has already pushed towards this direction, and set out the criteria for an effective anti-corruption compliance program. It identified eight core elements, including investing sufficient resources to compliance activities, and promoting a culture of compliance.[95] The agencies have also already publicized guidelines setting out principles for best practices for FCPA compliance programs.[96]

Nevertheless, the agencies are still rewarding such efforts *ex post* by treating them as signs of cooperation during settlements. In the future, the agencies are advised to substantiate these principles with more examples, and design an *ex ante* rewarding mechanism to clarify how companies that follow these guidelines could benefit in practice. For example, successful

[95] Deputy Attorney General Rod J. Rosenstein, *the FCPA Corporate Enforcement Policy* (Nov. 29, 2017), *available at* https://www.justice.gov/criminal-fraud/file/838416/download.

[96] U.S. Dept. of State, Fighting Global Corruption: Business Risk Management (2d ed. 2001), *available at* http://www.ogc.doc.gov/pdfs/Fighting_Global_Corruption.pdf. See also U.S. Dept. of Commerce, Business Ethics: A Manual for Managing a Responsible Business Enterprise in Emerging Market Economies (2004), *available at* http://www.ita.doc.gov/goodgovernance/adobe/ bem_manual.pdf.

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efforts could be mandatory sessions teaching the importance of a bribery-free business environment; it could also be implementing strict disciplinary rules prohibiting bribery, including demotion for first time offenders and immediate dismissal for serious or repeated violations. Companies could also delegate the power to the board of supervisors or adopt a special independent body to oversee proper business operations overseas.

B. Redefine FCPA Individual Liability in the Long Term

One of the main thesis of the article is the lack of statutory basis and investigative means to hold individuals who have committed bribery or tried to cover them up on a balance sheet accountable. Two final solutions are to lower the legal standards to hold more individuals accountable and increase the FCPA enforcement resources.

On a legislation level, the legislature might consider extend the statute of limitation, lower the specific intent requirement to impose a near strict liability, and repeal other statutory hurdles under the FCPA. In addition, enact laws and regulations to expand and clarify the scope of the FCPA to avoid judicial second-guessing restricting its applications is also an effective tool.

On an investigative level, the agencies must augment their ability to combat corruption overseas and work with overseas forces. In the past, the SEC made achievements in the actions against various executives of Siemens, Noble, and Magyar Telekom, and FLIR Systems;[97] the Department added 10 more prosecutors to the DOJ and increased its FCPA unit by more than 50%; and the FBI devoting three new squats to FCPA-related tasks.[98]

There was some collaboration among law enforcement around the globe in the past. Foreign regulators were increasingly active in prosecuting companies for bribery, including the U.K. Government's Serious Fraud Office ("**SFO**"), German prosecutor's office, Royal Canadian Mounted Police, and China's Admin-

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[97] Andrew Ceresney, *Remarks at 31st International Conference on the Foreign Corrupt Practices Act* (Nov. 19, 2014), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370543493598.

[98] U.S. Dep't of Justice, *The Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance* (Apr. 5, 2016), *available at* https://www.justice.gov/opa/file/838386/download.

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istration of Industry and Commerce and Public Security Bureau. In the GSK case,[99] the SFO liaised its American and Chinese counterparts to combat bribery in the pharmaceutical industry. Alcoa and Alstom also included a multi-jurisdictional component as the SFO cooperated with the DOJ and SEC extensively during the U.S. government's investigations. But the rarity of these cases illustrate how there must be much more powerful task force and global cooperation to implement the FCPA.

Unfortunately, with the legislative infrastructure and enforcement investment spared to the FCPA at the present, none of these proposals is obtainable in the near future. With the current Trump government, we might be expecting a longer timeframe to achieve this long-term goal.

VII. CONCLUSION

It might be true that a lay person would intuitively feel justice was done when an individual goes to jail under the corporate context. A legal professional curbs her urges and rationally analyzes what is the optimal solution, that is deemphasizing enforcements against individuals and reemphasizing boosting the overall level of enforcement against all corporate wrongdoers.

As demonstrated, the reason for few individuals going to jail were because of the existing obstacles in how the law is structured, and how investigations and enforcement could be costly and nearly impossible in the current regime. Agencies' efforts in the Yates Memo and the FCPA Corporate Enforcement Policy have loopholes and could at best be a repetition of the past efforts. The best way to address the problem is to go to the core issue. That is to enhance the overall prosecution rate, to dampen companies' desire to break the law, and, with the penalties "contributed" by these companies, to equip the agencies with better capacity to investigate either individuals or companies on their own and with the assistance from other jurisdictions.

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[99] *In re* GlaxoSmithKline plc, Exchange Act Release No. 3-17606 (Sep. 30, 2016). *See also* U.S. Dep't of Justice, *The Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance* (Apr. 5, 2016), *available at* https://www.justice.gov/opa/file/838386/download.

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