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Contracts, Inequality, and the State

Contract Law Ultra-heterodoxy in China

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4.1 INTRODUCTION

This chapter examines the role of contract law in tackling inequality unveiled by the COVID-19 pandemic, with a focus on China, where courts seem to have made the most drastic moves. Whether contract law has any role to play in addressing economic inequality is the focal point of a long-lasting debate among contract law scholars.[1] The orthodox view of contract law contends that contract law is expected to guarantee freedom of contract, individual autonomy, and efficiency rather than bearing extra burdens of pursuing distributive justice; for the latter, tax law and fiscal policies are more effective and legitimate tools.[2] In comparison, Kevin Davis and Mariana Pargendler have recently pointed out the trend of contract law heterodoxy in developing countries.[3] This heterodox approach to contract law moves beyond the conventional doctrines relating to the validity and enforceability of contracts of contracts, such as frustration, duress, and misrepresentation, to correct injustice on additional grounds.[4] Courts in countries such as Brazil, Colombia, and South Africa have been willing to alter or void unfair contract terms in order to protect weaker parties on the grounds of distributive justice. Against this backdrop, I find that neither orthodox nor heterodox approaches can explain Chinese courts' drastic

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[1] K. E. Davis and M. Pargendler, Contract Law and Inequality (2022) 107 *Iowa Law Review* 1485–542.

[2] It is argued that the US Constitution's Contract clause was designed to prevent laws that alter contracts for distributive purposes. Ibid, 1498.

[3] Ibid.

[4] M. Chen-Wishart, *Contract Law* (Oxford: Oxford University Press, 2012), p. 197.

approach to dealing with inequality. Chinese courts have gone further to espouse what I term "ultra-heterodoxy" to denote the greater latitude they enjoy in deciding cases that impact inequality.

The debate between contract law orthodoxy and heterodoxy has not received much attention in Asia. This is in part because of the civil law tradition existing in most Asian countries. Contract law in Asia usually gives judges broad discretion to review the validity of contracts according to public interest and fairness considerations, thereby approximating it to the type of legal heterodoxy that Davis and Pargendler describe in the Global South. For example, the Civil Codes of Japan, South Korea, Taiwan, and China all provide that contracts and other legal acts should be deemed void if they violate social morals, public order, and social customs.[5] Other cultural factors also contribute to the appeal of a more socially- and policy-oriented approach to contract law in Asia, including the country's political economy, people's communitarian values, the perception of the role of state, and even the paternalistic function of the legal system. As a result, compared to the common law of contract, contract law in Asian civil law countries allows much greater regulatory and legislative intervention, and subjects contracts to other special laws that amend contractual obligations for policy reasons, such as consumer protection, financial stability, fairness, and healthcare considerations. Such regulatory intervention in contract law reflects the perception of the state in civil law systems, which is generally expected to be the guardian of public interests and freedom rather than the enemy of liberty.[6] All in all, civil codes in Asia and the prevailing legal culture provide ample scope for heterodox approaches.

In view of the different role of state in private contract relationships, this chapter aims to examine contract disputes in China during the pandemic to explore how the strong Chinese party-state intervenes in the private sphere to tackle economic inequality. By way of background, inequality is a serious issue in China. In 2021, China's Gini coefficient reached a score of 0.46, which indicates a high level of income inequality.[7] Rich and powerful market actors have better capacity to engage with sophisticated contractual arrangements than weaker market actors do. In the case of financial products, for example, complex contractual arrangements, such as securitization of assets and prioritization of varying debts, could facilitate the persistence of inequality by exploiting weaker parties who do not have the capacity to understand the nuances of contract terms. In this regard, it is understandable that

[5] For example, Art. 72, Civil Code of Taiwan (1929); Art. 153, Civil Code of The Republic of China (2020); Art. 103, Civil Code of South Korea (1958); Art. 90, Civil Code of Japan (1896).

[6] For a general discussion, see M. Damaska, *The Faces of Justice and State Authority*: A Comparative Approach to the Legal Process (New Haven: Yale University Press, 1986), pp. 71–96; J. Whitman, 'The Two Western Cultures of Privacy: Dignity versus Liberty' (2004) 113 *Yale Law Journal* 1151–222.

[7] C. Textor, Gini Index: Inequality of Income Distribution in China 2004–2021, *Statista* (September 29, 2023).

China's nascent legal system coupled with the limited access to it by lay people could help institutionalize and increase such inequality. Like elsewhere, the COVID-19 pandemic has worsened preexisting inequality in China.[8] Such inequality may well manifest itself in increasing contract disputes. As a matter of fact, during the latter part of the pandemic, disputes over contracts, which may or may not have been unequal and exploitative in nature, led to street protests by angry contract parties from time to time in the context of both consumer and commercial arrangements.[9] Such anger and frustration also destabilized the financial system because many financial institutions have been involved in those transactions in dispute.[10] As a result, the Chinese state, seriously concerned about spreading impacts, has tried hard to resolve such disputes.

It is not a secret that the Chinese state will intervene in political cases and in cases involving state interests.[11] Yet, in private contract disputes, the state also intervenes to tackle inequality. In doing so, the state faces a similar tension between contract law orthodoxy and heterodoxy, trying to strike a balance between exchange efficiency and distributive justice, both of which greatly affect the legitimacy of the party-state. This tension could be observed in some contract disputes that led to serious political challenges. In 2022, for example, massive numbers of home buyers in several provinces of China collectively refused to pay their mortgage loans as a way of protest on the ground that the contract terms with real estate developers and their banks had resulted in unfair and unbearable hardship during the pandemic.[12] Such protests struck a nerve for the Chinese government because these consumers legitimately called for economic justice but at the tremendous cost of stability of the financial system.

This chapter thus examines the ways in which the Chinese state and courts dealt with such contract disputes during the pandemic and describes their ultra-heterodox approaches to the relationship between contract law, inequality, and the state. The approaches to contract disputes within the Chinese state also reflect a unique construction of legality that I term "negotiated legality," in which all stakeholders subject legality to negotiations during the contract enforcement process with the goal of delivering substantive justice rather than demarcating strict winners and losers. I have identified three modes of ultra-heterodoxy applied by the Chinese

[8] W. Wan, J. Wang, and W. Jiang, Does COVID-19 Exacerbate Regional Income Inequality? Evidence from 20 Provinces of China (2023) 15 *Sustainability* 1–16.

[9] See, e.g., K. Slaten, Grassroots Protests Are Frequent in Xi Jinping's China, *Freedom House* (November 17, 2022); Bloomberg News, Sweeping Mortgage Boycott Changes the Face of Dissent in China, *Bloomberg* (August 3, 2022).

[10] See, e.g., C. Lo, The Risks around China's Grassroots Mortgage "Boycott," *BNP Paribas* (July 26, 2022).

[11] See K. Hang Ng and X. He, *Embedded Courts: Judicial Decision-Making in China* (Cambridge: Cambridge University Press, 2017).

[12] I. Qian and A. Chang, They Poured Their Savings into Homes That Were Never Built, *New York Times* (January 24, 2023).

courts, in which continuing negotiations can be observed. Such negotiations over legality are only possible because of factors such as China's unique political economy that allows the party-state to intervene in private contractual relationships; various communitarian norms surrounding liability, which can be employed by judges; and the motivations behind state actors' efforts to secure broader policy goals, including maintaining economic stability and preventing social unrest.

This chapter explores how the Chinese party-state and courts tackled inequality in contract disputes during the pandemic and is organized as follows. Section 4.2 offers a brief comparison between China and other countries in terms of the general approach for dealing with contract disputes during the pandemic. Section 4.3 describes the three approaches that make China different from other countries, followed by Sections 4.4–4.6, which discuss each of the approaches. In Section 4.7, I analyze the implications on administration of justice in light of my case study in China – particularly, the "negotiated legality." Section 4.8 concludes.

4.2 DEALING WITH CONTRACT DISPUTES DURING THE PANDEMIC

4.2.1 *Procedural Approach vs. Substantive Approach*

During the peak of the pandemic, many counties passed legislation, much of which remains in force, to give breathing space for contract parties that faced financial difficulty.[13] Most laws seeking to provide relief from the effects of COVID-19 (including those of the United States, United Kingdom, Australia, and Singapore), provide temporary, procedural relief. Typically, companies or individuals are granted an extended grace period to repay their debts. It is also common for such COVID-19 legislation to raise the statutory threshold for creditors to apply for an injunction or file for bankruptcy against their debtors.[14]

COVID-19 legislation in Asia does not substantively revise the underlying rights and obligations between contract parties. For example, Singapore's COVID-19 (Temporary Measures) Act states that the monetary threshold for creditor companies to petition for an insolvency of a business increased from S$10,000 to S$100,000, but at the same time the regulators emphasized that the banks' contract rights to charge

[13] For example, Singapore's COVID-19 (Temporary Measures) Act 2020 (No. 14 of 2020) remains in effect as of February 2025. In Taiwan, the ordinance to mitigate defaults in construction contracts due to the pandemic also remains effective as of February 2025. See Public Construction Commission of Executive Yuan, The Guidelines for Non-Performance of Construction Contracts Caused by the Pandemic (2022); Public Construction Commission of Executive Yuan, Directive No. 11001006870 (2021).

[14] See, e.g., Section 20 of Singapore's COVID-19 (Temporary Measures) Act 2020. Australia also increased their threshold for bankruptcy notices issued by a creditor's petition from AUD 5,000 to AUD 20,000. For more information, see M. Murray, Managing the Insolvency Curve in Australia, *Oxford Business Law Blog* (April 20, 2020).

fees and interest for non-payment or late payment of loan obligations was not affected.[15] The Act mitigates the consequences of loan defaults only procedurally.

Notably, this procedural model still endorses market mechanisms as well as contract law orthodoxy in that it avoids compromising individual autonomy and freedom of contract. On the one hand, it strongly encourages contract parties to negotiate a solution; on the other, the regulators do not prescribe any substantive solution for parties. Regulators in several major Asian economies have issued directives to suggest that contract parties engage in negotiations under preexisting change in circumstances doctrine and the temporary procedural measures announced. For example, Taiwan's Public Construction Commission issued directives to instruct that the pandemic could be deemed as "force majeure" and hence qualify for the application of the contract law doctrine of "change in circumstances" to avoid related obligations.[16] Similarly, the Monetary Authority of Singapore suggested that small- and medium-sized enterprises work with their banks to explore solutions made available by individual banks and take into account any late charges and higher interest, as well as the possibility that they may end up paying more in the future. This is because, as in other jurisdictions, the country's COVID-19 Act only extends the grace period but does not substantively affect contract terms about late payment charges.[17] The final solution must remain subject to private negotiations.

By contrast, China employed a very different approach, which did not hesitate to substantively revise the rights and obligations of contract parties to solve disputes and address policy concerns during the pandemic. The People's Supreme Court of China and its intermediate courts have selected and published several exemplary cases as a form of guidance for judges to deal with COVID-related contract disputes.[18] By analyzing these precedents, this chapter identifies three different approaches that Chinese courts have employed. All of the three approaches not only echo contract law heterodoxy but also move beyond it. I call these approaches examples of "ultra-heterodoxy in contract law."

4.2.2 *Practices of Contract Law Heterodoxy*

China's ultra-heterodoxy appears only in certain types of contract disputes that seriously concern inequality and public policies; for less serious cases, Chinese judges behaved similarly to their counterparts in other Asian countries and adjudicated according to contract law doctrines as well as some ad hoc directives announced by regulators during the pandemic. For example, Articles 6, 7, and

[15] Monetary Authority of Singapore, Comments by MAS on Covid-19 (Temporary Measures) Bill, Monetary Authority of Singapore (April 1, 2020).

[16] Public Construction Commission of Executive Yuan, The Guidelines for Non-Performance of Construction Contracts Caused by the Pandemic.

[17] Monetary Authority of Singapore, Comments by MAS on Covid-19, 4.

[18] People's Supreme Court of China, Guidelines on Proper Trial of Civil and Commercial Cases related to Coronavirus Pandemic (May 2020).

8 of PRC Civil Code state the basic principles that a legal entity cannot violate social morals, fairness, and good faith in their legal transactions. As basic principles instead of mere legal doctrines, they serve as the overarching notions that bind legal interpretation and seal any legal loopholes.[19] Article 534 further empowers courts to monitor and regulate contracts that violate national interest and public interest. Under this doctrine, Chinese judges altered or voided the contractual obligations of contract parties, and sometimes required them to renegotiate a new contract.[20] The doctrine most commonly applied by Chinese judges in pandemic-related cases is the "change in circumstance" clause, which allows judges to amend or void contract obligations in the event of a change in circumstance that the parties did not foresee and that would result in unfairness and inequality.[21]

For example, face masks were in short supply during the pandemic, so disputes regarding mask production agreements were common. In such cases, courts frequently applied the doctrine of "change in circumstance" to alter contract terms in favor of weaker parties. While some cases were not inequality-related as the problems were caused by unexpected, volatile market conditions, many cases did involve strong market players taking advantage of their market position to exploit weaker parties, such as when price increases by a wholesaler caused defaults by small retailers, or when a manufacturers' willful blindness of their limited manufacturing capacity caused buyers' subsequent defaults in other resale contracts.[22]

For these less severe cases, Chinese regulators also behaved similarly to their counterparts in other Asian countries. The Chinese government issued COVID-related directives to offer temporary, procedural relief. For example, the China Banking and Insurance Regulatory Commission (CBIRC) required commercial banks to extend grace periods for individuals and small- and medium-sized enterprises that defaulted on their loan agreements.[23] Also, financial institutions were required to be less stringent about loan defaults by debtors in certain types of

[19] F. Yu, The Distinction between Basic Principles and General Clauses: The Interpretation Methodology for Interpreting the Principles of Good Faiths and Social Morals (2021) 4 *China Legal Science* 25–43 [于飛, 基本原則與概括條款的區分：我國誠實信用與公序良俗的解釋論構造, 中國法學].

[20] For example, People's Supreme Court of China, Selected Cases about Labor Employment Disputes, vol. 1, No. 6 (July 10, 2020) [最高人民法院联合发布第一批劳动人事争议典型案例之六：李某与某餐饮公司劳动争议纠纷案]; Jiangsu Wuxi People's Intermediate Courts, Ten Selected Precedents about Commercial Contract Disputes during the Pandemic, No. 4 (2020) [江苏省无锡市中级人民法院发布10起涉疫情商事合同纠纷典型案例之四：甲公司与乙公司、丙公司关于口罩买卖合同纠纷案].

[21] Art. 533 of the Civil Code of The Republic of China (2020).

[22] Jiangsu Wuxi People's Intermediate Courts, Ten Selected Precedents about Commercial Contract Disputes during the Pandemic.

[23] China Banking and Insurance Regulatory Commission (CBIRC), Notice about Offering Finance Services for Firms in Distress during the Pandemic, No. 64 (2022) [中国银保监会办公厅关于进一步做好受疫情影响困难行业企业等金融服务的通知, 银保监办发〔2022〕64号].

vulnerable industries, such as transportation, travel, and hotels, or by poor and underprivileged debtors such as peasants.[24]

Nonetheless, compared to Singapore and Taiwan, the Chinese state has gone further in some of its directives to substantially revise certain terms to reduce the legal consequences of contract defaults. For example, banks were required to not exercise their rights against debtors to ask for early repayment, lower debtors' credit lines, or terminate loan agreements altogether.[25] Accordingly, to compensate those banks for the rollback of their rights, CBIRC raised the allowable bad loans ratio in financial institutions up to 3 percent and promised not to hold such an increase in bad loans against the performance evaluation of bank managers.[26] The Chinese government also offered relief measures to prevent defaults on other types of contracts. For example, with respect to landlord and tenant agreements, landlords of state property were required to reduce rents for three to five months for their tenants[27]; in return state-owned banks would offer favorable loans with lower interest rates to such landlords. Landlords of private property who reduced rents for tenants could also enjoy similar financial benefits.[28] Here, the Chinese state utilized its leverage over strong market players to make them more lenient with weaker parties.

4.3 MOVING FROM HETERODOXY TO ULTRA-HETERODOXY OF CONTRACT LAW

With respect to contract disputes that seriously concern inequality and public policies, however, Chinese judges do not want to apply codified doctrines to exert their discretionary power. There are several reasons for this. A typical reason is the concern of their own legitimacy being questioned if they unilaterally alter the contract terms. There are cases in which the judges could have made a straightforward decision by relying on the doctrine of "change in circumstance," but they did not, due to worries that the decision would trigger backlash by upset parties.[29]

Another reason comes from the style of judicial administration in a civil law system. In civil law jurisdictions, it is an established norm that judges should apply concrete laws first to adjudicate before they resort to abstract doctrines including

[24] China Banking and Insurance Regulatory Commission Helongjian Branch, Directive about Further Leniency and Support for Financial System during the Pandemic, No. 3 (2020) [中国银保监会黑龙江监管局 关于进一步落实监管容忍政策 加大疫情期间金融支持力度的通知, 黑银保监发〔2020〕3号].

[25] Ibid.

[26] Ibid.; CBIRC, Notice about Offering Finance Services for Firms in Distress during the Pandemic, Art. 17.

[27] China Banking and Insurance Regulatory Commission (CBIRC), Support for Landlord that Reduced Rents, No. 64 (2022) [对减租人给予支持, 银保监办发〔2022〕64号 (十四)], Art. 14.

[28] Ibid.

[29] In this regard, the type of Chinese courts' behavior was in line with concerns expressed by the contract law orthodoxy. See Davis and Pargendler, Contract Law and Inequality.

their discretionary power that allows them to nullify a contract, for example, on the ground of violation of public morals and social customs. For instance, during the 2008 global financial crisis, the People's Supreme Court of China instructed district judges to work hard to stabilize the economic order by adjusting contract terms according to the "change-in-circumstance" clause under the General Principles of Civil Code (1987) but required them to not directly apply this doctrine unless higher courts approved.[30] Similarly, the Supreme Court of South Korea strictly limits the application of force majeure doctrine and holds that even the MERS (Middle East respiratory syndrome) outbreak and Asian Financial Crisis did not meet the threshold of force majeure.[31]

Most importantly, Chinese judges do not think the codified discretionary power, which provides room for contract law heterodoxy, is sufficient for dealing with cases that raise serious concerns about inequality. Here, both contract law orthodoxists and Chinese judges reject heterodoxy but differ strikingly on their rationales. The orthodoxists argue that courts should refrain from using contract law to deal with inequality for various reasons, such as respect for individual autonomy, lack of legitimacy to intervene, freedom of contract, or the existence of other better tools. In comparison, Chinese judges believe the opposite – they should try all possible legal means to alter or bypass contract terms that have caused inequality and its consequences. Being generally reluctant to invalidate contracts, Chinese judges are instead instructed, as per the People's Supreme Court of China's guidance, to alter contract terms to achieve greater societal goals. In short, contract law heterodoxy is not good enough for Chinese judges; they need ultra-heterodoxy.

By examining the selected exemplary cases issued as guidance, I have identified three approaches through which courts have been able to alter or circumvent contracts in order to obtain greater latitude in addressing inequality and its impact on public order. I relied on the Peking University legal database (Pkulaw.cn) to collect 123 selected precedents and cases by searching broadly under several key words: the pandemic, inequality, change-in-circumstance, contract disputes.[32]

The first approach is mediation, through which judges would not be strictly bound by contract terms. The mediation approach is used to deal with disputes that require remedies not entirely in accordance with legal rights but impose externalities on social and financial stability. When judges foresaw that the lengthy

[30] People's Supreme Court, Notice about Correct Application of PRC Contract Law for Serving the Party and National Macro-Policies, *Law* (2009) No. 165 (2009).

[31] As in many civil law countries, the main doctrinal threshold is whether the risk is unforeseeable and whether the risk is beyond the realm of control by the default party. In practice, however, the threshold actually seems higher. It is a stretch to say that a MERS outbreak is foreseeable. See Kim & Chang, COVID-19: Force Majeure under Korean Law Considered in Wake of COVID-19 Pandemic, Kim & Chang (April 4, 2020).

[32] My collection of cases overlaps with the batches of guiding cases published by the People's Supreme Court of China and its Intermediate Courts to guide judges to adjudicate COVID 19-related contract disputes.

litigation process would be harmful for social and economic order, or that adjudication would create backlash, from either stronger parties or weaker parties, they would move disputes from litigation to mediation. In China, judges can act as mediators in cases they are hearing as judges. They also adopt an evaluative approach, under which they actively present strategies for resolving the dispute at hand, as opposed to facilitative mediation, which focuses more on neutrality and facilitating negotiations.[33] In relation to pandemic disputes, the People's Supreme Court of China also issued guidance to encourage mediation.[34]

The second approach is insolvency procedure. Courts will press companies/debtors to move disputes into insolvency procedure if they involve large numbers of weaker parties in great frustration and could trigger significant social unrest. Judges are mainly concerned about the political consequences of economic inequality. The insolvency approach allows judges to bring all stakeholders and respective contracts into a single legal proceeding, thereby finding a holistic solution. Under the insolvency approach, government officials and cadres of the Chinese Communist Party ("the Party") are also involved to play a complementary role.

The last approach is the macro-prudential approach, which echoes the macro-prudential policy developed after the 2008 global financial crisis to address systematic risks inherent in financial systems. If the contract disputes have triggered serious concerns about financial stability, this approach will be applied. Here, time is essential, and risks have to be contained as soon as possible. The government and the Party would put themselves forward to lead the dispute resolution. Initially, the party-state bypasses not only contract terms but also the legal procedure but, at a later point, it brings the case back to the courts to seek judicial endorsement. In contrast to the insolvency approach, the courts play only a complementary role.

Before proceeding to examine these three approaches, it is worth highlighting two ways in which the findings reported below diverge from the existing literature on the Chinese legal system. First, collaboration between courts and the government has long existed in China and elsewhere in Asia. For example, as Frank Upham and John Haley have pointed out with respect to Japan, where the judiciary has been highly capable and independent, the implicit collaboration between the executive branch and the judiciary allows social problems to be identified and solved in a timely manner.[35] Similarly, in the case of Singapore, which has been ranked as one of the top rule-of-law countries, Thio Li-Ann has described the existence of a

[33] A. Godwin, Judicial Mediation, *China Business Law Journal* (online) (October 12, 2018). https://law.asia/judicial-mediation/.

[34] People's Supreme Court, Guidance about Rightfully Dealing with Civil Disputes during the Pandemic, No. 1 (April 20, 2020) [关于依法妥善审理涉新冠肺炎疫情民事案件若干问题的指导意见（一）].

[35] F. K. Upham, Reflection on the Rule of Law in China (2011) 6 *National Taiwan University Law Review* 251–68; J. Haley, Constitutional Adjudication in Japan: History and Social Context, Legislative Structures, and Judicial Values (2011) 88 *Washington University Law Review* 1467–92.

collaborative, rather than adversarial, relationship between the executive and judicial branches of the government.[36] That being said, the level of government–court collaboration in China is the most extensive. Since 2021, the government and courts have begun to officially promote the so-called Government-Court Collaboration Model (府院聯合模式), which deems the doctrines of separation of power and judicial independence incompatible with the Chinese context.

The second point worth noting is that the ownership structure of parties in dispute does not seem to matter to the application of the three approaches. In other words, courts and government do not take into account whether contract parties are state-owned enterprises (SOEs), private firms, governmental agencies, or individuals. Rather, the merit of cases and their impacts are the key factors in choosing which approach to apply. Traditionally, Chinese courts, whose budgets come from local governments, would practice regional protectionism and thereby take a favorable position toward SOEs and state actors in the region. However, through an evaluation of the selected cases, it does not appear that the identity of the parties in disputes play a role in determining the applicable approach. As long as a contract dispute may cause externalities in the form of social and financial instability, judges will choose one suitable approach to apply. Hence, this judicial policy seems more impersonal than before, although it may be limited to pandemic-related contract disputes only. Nonetheless, it remains to be observed whether the three approaches may evolve into a more general model of justice administration and continue to operate in the post-pandemic era.

4.4 ULTRA-HETERODOX MODE ONE: THE MEDIATION APPROACH

In 2022, Chinese courts settled a total of 8.95 million disputes through mediation, up by 46.6 percent year on year, and this is approximately one third of the disputes brought to courts.[37] Courts use the mediation approach under several circumstances. The most common scenario is caused by the difficulty under the pandemic that rendered a normal legal proceeding impractical. For example, a property management company had a dispute against twenty-one property owners during the time when the whole housing complex was put under quarantine. Given the imposed quarantine order, the judges advised all parties to switch to mediation and used telephones and WeChat, the Chinese version of WhatsApp, to complete the mediation.[38] Here, courts tried to use mediation to gain more flexibility and did not have to be bound by formal procedure.

[36] L. A. Thio, We Are Feeling Our Way Forward, Step by Step, in Albert Chen (ed.), *Constitutionalism in Asia in the Early Twenty-First Century* (Cambridge: Cambridge University Press, 2014), pp. 270–94.

[37] Xinhua, 'Chinese Courts See Increase in Pre-litigation Mediation', *China Org* (February 16, 2023).

[38] High Court of Inner Mongolia, Selected Cases on the Online Resolution of Covid-19 Disputes, No. 6 (March 26, 2020) [内蒙古高院发布首批新冠肺炎疫情期间在线化解纠纷典型案例之六：某物业服务公司与刘某等21名业主物业服务合同纠纷案].

What is more relevant for the purposes of this chapter is that courts use mediation not only to circumvent procedural requirements but also to bypass substantive contract terms in order to facilitate renegotiation between the parties. Notably, contracts in China do not necessarily reflect the outcome of due diligence and business negotiations; rather, contracts merely represent the beginning of a long-term business relationship. A boilerplate contract could be quickly executed by parties without being thoroughly reviewed. Subsequently, the terms of contract are subject to renegotiation between the parties when they realize the terms do not work practically. Therefore, when disputes arise, it is a norm that renegotiation is allowed. In a dispute, judges are expected to facilitate renegotiation, instead of being an adjudicator. Contract terms remain as a mere default position for further negotiation rather than a binding legal undertaking. Parties are looking for a solution acceptable by all major stakeholders, instead of a one-sided solution. Hence, mediation offers the most suitable platform for such renegotiations and also provides judges flexibility to address contract inequality.

4.4.1 *Discretion beyond Contract Terms*

Specifically, courts have proceeded beyond enforcement of contract terms via mediation for two main reasons. First, mediation allowed courts to carry out their policy mandate during the pandemic. Second, mediation allowed courts to accommodate extralegal business customs that failed to function during the pandemic.

To begin with, the political embeddedness of the judiciary renders the courts an extension of the state itself; therefore, courts are also tasked with executing the state's policy objectives aside from merely adjudicating disputes.[39] During the COVID crisis, the mandate of judges was to support business operations such that production could continue and unemployment would not increase. This mandate was unlikely to be achieved if judges adjudicated disputes according to contract terms and civil procedure law. Some district courts even issued their own directives as to how to maintain and restore market order during legal proceedings.[40] Most parties involved in this type of mediation are firms that played a vital role in providing public services (such as wastewater treatment,[41] road pavement and

[39] B. Ahl, Why do Judges Cite the Party? References to Party Ideology in Chinese Court Decisions (2020) 18 *China: An International Journal* 175–85, 185.

[40] For example, Xuzhou Intermediate Court, 15 Measures to Protect Small and Medium-Sized Firms' Development under the Covid Control Policy (2020) [徐州中院, 出台疫情防控形势下服务保障中小微企业发展的15项举措]; Qindao City Jimou District Court, Suggestion on Judicial Protection and Services under the Covid-Control Situation (2020) [青岛市即墨区人民法院,关于为新型冠状病毒肺炎疫情防控工作提供司法保障和服务的意见].

[41] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 3, No. 5 (April 22, 2022) [最高人民法院发布第三批13个全国法院服务保障疫情防控期间复工复产典型案例之五：湖北荆州某水业有限公司执行案].

repairs,[42] or telecommunication),[43] offering local jobs, and contributing to local tax revenues. Employees and workers were not necessarily parties to the disputes, but they suffered significantly when the employers stopped operations. Interestingly, courts seemed to be more concerned with how to get their employees back to work than with the merit of disputes. This reflects how the courts used mediation to give effect to the government's policy mandate of continuing operations and curbing unemployment. In contrast, if the dispute would not have a significant economic impact, courts were more likely to adjudicate it.[44]

As such, judges realized that adjudication procedures, such as injunctions against the companies' assets and bank accounts, would only further disrupt the firms' operations. Employees cannot be paid and raw materials cannot be purchased if the trial proceeds.[45] In some cases, judges even had to help to remove injunctions already imposed on companies' assets during the pre-trial procedure,[46] or restore the defaulting parties' credit rating.[47] Adjudication, coupled with various injunctions during formal civil procedure, would worsen public services and negatively affect the local economy, thereby frustrating the courts' mandate.

In such cases, courts were not shy in expressing the rationale of their decisions to move cases from trial to mediation. For example, one case involved a large meat processing company that defaulted on its loan agreements with a local bank during the pandemic. Consequently, an early repayment clause was triggered. After the dispute was brought to court, the district court engaged in mediation instead of

[42] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 3, No. 8 (April 22, 2022) [最高人民法院发布第三批13个全国法院服务保障疫情防控期间复工复产典型案例之八：贵州某路面有限公司买卖合同纠纷执行案].

[43] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 1, No. 6 (6 March 2020) [最高人民法院发布首批十个全国法院服务保障疫情防控期间复工复产民商事典型案例之六：苏州资产管理有限公司诉苏州德威系关联企业金融借款纠纷系列案].

[44] For example, a dispute between a movie theater operator and its contractors caused the closing of the movie theater. As such a closing would not have any significant impact on social and economic order, the court went ahead to adjudicate it rather than switching it to mediation.

[45] In a case involving a high-tech company, the court realized that 2,000 employees could not receive their salary because of an injunction made to the firm's all bank accounts during the pre-trial proceeding. The court quickly move the case into mediation so that such injunctions can be removed. People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 1, No. 8 (March 6, 2020) [最高人民法院发布首批十个全国法院服务保障疫情防控期间复工复产民商事典型案例之八：东证融汇证券资产管理有限公司诉光一科技股份有限公司等质押式证券回购纠纷案].

[46] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 1, No. 3 (March 6, 2020) [最高人民法院发布首批十个全国法院服务保障疫情防控期间复工复产民商事典型案例之三：上海丽景针织制衣有限公司诉合玺（上海）服装有限公司等买卖合同纠纷系列案].

[47] Ningbo Medical Instrument Co. Case (2019) [宁波某医疗器械有限公司], available at F. Dou, S. Cheng, and A. Zhang, *Analysis of Legal Issues Related to Bankruptcy of Enterprises under the Influence of the Epidemic* [疫情影响下与企业破产相关的法律问题解析], Allbright Law Offices (February 14, 2020).

adjudication. During the mediation, instead of reviewing the loan agreement terms, judges emphasized the moral principle of "being sympathetic and being accommodating to one another."[48] The mediation quickly helped restore the firm's credit record, resume contract performance, and continue the business operation after the firm agreed to provide additional loan guarantees. The People's Supreme Court endorsed the decision by emphasizing the decision of the District Court as a model of how to use court proceedings to support major employers and taxpayers.[49]

Second, by using mediation, courts can accommodate and sustain some extralegal or even illegal contractual agreements. In such cases, the original written contracts usually do not reflect the genuine intention of contract parties. Their business could be based on some extralegal arrangements which are part of common business customs in China. Such noncompliance is considered a violation of law and policies set by the central government but might be viewed as beneficial and even necessary for business at the local level. Courts as part of local government would be sympathetic and therefore try to accommodate such extralegality that facilitates local business. For example, it is a common practice that sellers issue receipts of payments and deliver goods to buyers before buyers actually make the payment. Sellers often agree with buyers that payment can be made at a later point in time, probably after the sale of goods. In this way buyers can obtain better liquidity while sellers could be more competitive by offering this favorable condition. However, such an agreed term is not stipulated in contracts because issuing receipts without actual payments can be viewed as tax evasion and subject to criminal prosecution.[50] Later, when buyers experienced financial difficulty during the pandemic, they claimed, based on the receipts sellers issued, that full payment had been made.[51] In such cases, it would not help solve the dispute if judges stuck to formal contract documents and ignored the illegal side agreement. Judges would have to accommodate such business customs rather than take these contract terms at their face value. Considering the difficulty in rebuking the validity of receipts due to years of complicated payment records between buyers and sellers, courts used mediation procedures to bypass written contract terms and avoid unjust enrichment.

[48] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies, Vol. 1 (March 6, 2020) [最高人民法院发布首批十个全国法院服务保障疫情防控期间复工复产民商事典型案例之五：中国农业银行股份有限公司浮梁县支行诉景德镇康源农业发展有限公司金融借款合同纠纷案].

[49] Ibid.

[50] It could be a serious crime for sellers to issue receipts without receiving the exact amounts stated in the receipts. Such fake receipts with inflated numbers could be used for the purpose of tax deduction and therefore considered as tax evasion. Xin Hua News, *Strict Prohibition on False Receipts and Tax Evasion in order to Maintain a Fair Market* [我國嚴打虛開發票和騙稅行為維護市場公平], Finance People (September 2, 2018).

[51] Beijing Fentai District People's Court, The Right Way to Construct the [Business] Model of "Receipt First, Payment Later" [先开票后付款的正确打开方式], Fentai District People's Court (April 30, 2021).

Other typical extralegal arrangements are designed to bypass China's capital controls. For example, a firm based in China would collaborate with a trustworthy overseas partner that is willing to issue an invoice with a contract price higher than the actual price of goods it sells. In this way, the company in China could obtain a legitimate reason to wire extra money overseas. Today, this strategy has been widely adopted by Chinese companies, foreign or local, to circumvent capital control regulations. Chinese regulators have tolerated or simply do not have the capacity to correct this industry custom. From time to time, such extralegal contracts would give rise to disputes when the collaboration goes sour. The overseas partner would claim the inflated consideration according to the written contract and refuse to return the extra payment according to the parties' illegal side agreements. By the same token, it does not help to solve the underlying issue if judges simply nullify such illegal agreements and inform the tax bureau to prosecute these parties for tax evasion. Courts at the local level are concerned more about the business environment and market order in the localities than the capital control policies set by regulators in Beijing. Hence, judges would adjudicate beyond contract terms to accommodate such business norms that maintain economic stability. Mediation once again is the platform to prevent one party from obtaining unjust enrichment by taking advantage of the other party subject to capital control.

In short, while typical mediation focuses on determining liability through an alternative procedure, Chinese courts do not use mediation to determine winners and losers in a clear and concise fashion, but rather to seek greater flexibility and discretion necessary for carrying out their policy mandate. The extralegal transactions in dispute might violate the Civil Code and other national regulations, but they support the local economy and market order, and therefore prompt judges to resolve disputes beyond the contract terms. But, as no one can be sure whether an extralegal business model can be upheld in the long-term, the courts' attitude could create market uncertainty.

4.4.2 *Collective Risk Sharing through Communitarian Norms*

Among the selected mediation cases, judges have resorted to moral persuasion to press the parties to compromise, instead of using the codified discretionary power to revise contract terms. They emphasize communitarian norms that subsume parties' individual rights within the larger social good.[52] For example, the popular Chinese saying "going through hardship together" (共體時艱) is often stated in the reasoning. Judges also often cited other Chinese sayings such as "be sympathetic," and "collective risk sharing." The other policy-specific norm the courts often used was "to restore business as usual." With this norm, judges suggest to the creditors

[52] G. B. Chen, *Law without Lawyers, Justice without Courts: On Traditional Chinese Mediation* (Oxfordshire: Routledge, 2002), p. 8.

that they should not be overly aggressive so that debtors could continue their business. This is in line with the typical Chinese saying that denounces people for being "unforgiving and aggressive simply based on legitimate positions" (得理不饒人). All of these norms encompass a communitarian value requiring collective sharing of risks and losses during hardship.

By resorting to communitarian narratives through mediation, judges legitimize their decisions even without the support of the black letter law, thus persuading the stronger party to yield and avoid backlash from weaker parties. Although a clear decision is possible by using the equitable principles codified in the Civil Code, judges might foresee how adjudication would not solve but rather provoke more disputes. As such, Shanxi People's Intermediate Court emphasized that "judges should actually avoid a simple decision and enforcement, because that may add fuel to the fire from the perspective of the firms in distress."[53] For example, a disappointed sport fan sued a travel agency because it failed to execute the travel service for the plaintiff to support her favorite volleyball team at the 2020 Tokyo Olympics games.[54] If the Court relied on traditional legal principles, a straightforward decision based on force majeure principle could have easily decided on the justice as the travel agent should not be held liable for losses caused by travel bans and the closed-door policy of the 2020 Olympics Games under the pandemic. However, the judge decided to switch to mediation anyway to comfort this sport fanatic, who already submitted multiple suits, and persuaded the travel agency to share losses. Eventually, the plaintiff dropped all the claims. In this case, the court emphasized the need to "be sympathetic," and the concepts of "collective risk sharing," and "going through hardship together." By avoiding the strict adjudication of the dispute, which may cause losses to the aggrieved person, the court implicitly recognized the limitations of contract law in effectively solving disputes.

What underlies those communitarian norms is ex post renegotiation about loss sharing.[55] In some contract disputes, especially in those concerning extralegal or illegal business models, parties in fact had foreseen such future renegotiation at the time when they signed contracts. Knowing various risks and inevitable uncertainty in their contractual relationships, they took collective loss sharing as an implicit contract term, even without judges persuading them to do so. This challenges existing literature about China's communitarian norms in torts, which focuses on

[53] Shanxi Intermediate Court, 'Announcement on Selected Cases about Covid-19 Control and Preservation of Economic and Social Development' No. 4 (April 24, 2020) [陕西高院发布服务保障疫情防控和经济社会发展典型案例之四：胡某等诉陕西某实业有限公司商品房销售合同纠纷案].

[54] Chengdu Court, Selected Seven Types of Cases during the Pandemic, Vol. 3, No. 1 (October 14, 2020) [成都法院第三批涉新冠肺炎疫情七大典型案例之一：因新冠肺炎疫情致东京奥运会延期旅游合同纠纷调解案].

[55] See, e.g., B. L. Liebman, 'Ordinary Tort Litigation in China: Law versus Practical Justice?' (2020) 13 *Journal of Tort Law* 197–228; R. Stern et al., Liability beyond Law: Conceptions of Fairness in Chinese Tort Cases (2023) *Asian Journal of Law and Society* 1–24.

how courts require the community members to collectively share in losses.[56] In the context of contract disputes, however, the communitarian norm appears to operate in the earlier phase. Parties in commercial transactions seem to have made the implicit agreement on potential ex post renegotiation about risks and losses sharing when they enter into agreement. Later, when judges switch to the mediation procedure, this renegotiation norm enables judges to smooth the contract terms to achieve their policy mandate.

4.5 ULTRA-HETERODOX MODE TWO: THE INSOLVENCY APPROACH

The second approach the courts utilize to address issues of unequal contractual agreements is the insolvency procedure. Compared to the mediation approach, the insolvency approach is aimed at dealing with contract disputes that involve large numbers of contracting parties. For example, a dispute between real estate developers and home buyers could involve thousands of home buyers, developers, land sellers, banks, guarantors, mortgagors, contractors, and workers. It is not uncommon for a single case to involve more than 10,000 parties. Take the example of Evergrande, the largest real estate developer in China, which defaulted in 2021. Evergrande was infamous for its highly leveraged investment. Its employees were given lucrative monetary incentives to secure funding domestically and globally. Some funds were secured at the very early stage of development projects to compensate rural villagers from whom the company acquired land, but much of the funds were used neither for compensation nor construction, but for other investments, including those in shadow banking businesses. When the firm encountered crisis, most victims were economically weaker parties, including house buyers who handed over their life savings for houses that were never built, depositors who hoped to receive high interest payments promised by the shadow banking arm of the company, or land sellers who had not received their full compensation.[57]

Obviously, real estate developers in China are economic and political power players. They are able to obtain large pieces of land under China's state-owned land system and conduct highly leveraged investment within and beyond their core business. During the real estate market boom in China, many home buyers acted like American shoppers during the Black Friday sale. They waited in a long queue, rushed into developers' showrooms, and spent only a few minutes to choose a unit from a display map of the housing project.[58] After that, contracts of sale and mortgage were swiftly arranged and signed, usually without being informed of the deal structure and detailed terms. Most home buyers were required to pay in

[56] Stern et al., Liability beyond Law.

[57] H. J. He, Evergrande Debt Crisis; Stocks become Wallpaper?, *Wealth Magazine* (September 17, 2021); L. C. Wei and Y. Giao, CEO of Evergrande under Investigation, *Yicai* (January 7, 2023).

[58] Qian and Chang, They Poured Their Savings into Homes.

advance before developers began any construction work and had little say in contract terms and payment conditions. Buyers' payments were usually not properly protected by security interest, whereas the rights of developers, mortgage banks, and other project investors were well protected by a security package. Furthermore, with the protection of firms' limited liability and the business judgment rule, and without any personal pledge agreement signed, corporate leaders of these firms were able to avoid personal liability in these contract disputes and walked away safely when projects failed. By contrast, as shown in many disputes, buyers were required to continue to pay their mortgages to avoid default even after developers had long ceased construction due to financial difficulty.

The extremely unequal positions between creditors and debtors in such disputes have led to social unrest in China during the pandemic. In the summer of 2022, massive protests by home buyers across various provinces began to emerge. Protesters resorted to property rights and equitable principles and mobilized other home buyers to refuse to pay mortgages collectively. These protests struck a nerve with the Chinese government. As a result, the insolvency approach began to be widely used by courts to address this type of contract dispute. By comparison, in other similar cases about real estate development but involving fewer people and tensions, courts still adjudicated or used mediation.[59]

4.5.1 *Capacity beyond Civil Procedure*

In contract disputes, it is an established rule that judges are not allowed to unilaterally invite any third party to join the proceeding as a plaintiff or defendant. Neither can their judicial decisions bind any third party who is not a party to the contract in dispute. This *in personam* nature of contract, however, constrains judges' capacity to deal with contract disputes that involve massive numbers of stakeholders. Although Chinese judges have broad discretion under the Civil Code, which provides great scope for contract law heterodoxy, it is not good enough as judges need not only possess greater discretion but also greater institutional capacity for such types of cases.

Against this backdrop, judges found China's Enterprise Insolvency Law a better platform to resolve such multi-stakeholder disputes than mediation and the law of contracts. Procedure-wise, the insolvency law offers a 3-in-1 advantage as it has a built-in mediation procedure, corporate reorganization procedure (for firms that still have business potential), and bankruptcy procedure (for firms without any business prospects). During the pandemic (i.e., since 2019), insolvency cases increased by at least five- to ten-fold according to my interviews with bankruptcy lawyers in China. It should be noted that the majority of insolvency cases start with mediation and

[59] For example, Shanxi Intermediate Court, Announcement on Selected Cases about Covid-19 Control and Preservation of Economic and Social Development.

reorganization as these two procedures preserve the possibility to rescue the firms and maintain employment. The objective of reorganization is to resume business as usual by deviating from existing contract terms.

During the litigation process, judges would instruct parties that they may choose to stay in litigation or switch to mediation or insolvency.[60] Before the procedure started, in most cases, large numbers of weaker parties had already begun their petition to regulators and governmental agencies. Some petitions may have turned into protests, and such antagonistic circumstances are the last thing that the local officials want to see. Under financial and public pressure, defendants would usually accept the switch to the insolvency procedure, albeit reluctantly. Plaintiffs would also agree with this switch as they would feel empowered by standing together with other creditors. Once the insolvency procedure kicks off, the court may inform and involve all creditors and stakeholders in the dispute resolution process.[61]

In the insolvency procedure, courts can gain more authority over debtors, thereby adding pressure on stronger parties to yield to the demands of weaker parties. For example, judges forbid debtors from making payment to any other third party[62] and from leaving their residence area without the court's permission.[63] Per judges' discretion, courts could also nullify any contract made prior to the insolvency, where such contracts concern actions by debtors to conceal their assets and evade debt obligations.[64] Most importantly, courts could suspend the exercise of priority rights and security interest by preferred or secured creditors (e.g. financial institutions and major investors).[65] With such additional authority and discretion, judges can thereby bypass the terms and conditions of existing contracts, including those of contracts in dispute and those of other contracts not being contested.

With this leverage, judges are able to demand that secured creditors relinquish their security interest for the benefit of weaker creditors.[66] A study shows that the resistance from powerful secured creditors is the most challenging task during reorganization and the bankruptcy procedure.[67] This is understandable as these secured creditors, such as banks and other major lenders, usually have few

[60] See cases, e.g., the Second Batch of Commercial Law Precedents about Courts Restoring Production during the Pandemic [全国法院服务保障疫情防控期间复工复产民商事典型案例（第二批）], Case No. 7: Sichuan Southwest Medical Equipment Co.'s Switch from Contract Enforcement to Insolvency [案例7：四川西南医用设备有限公司执转破案] (April 20, 2020); Case No.1, Guandong Xingang Cement Company Settlement (April 26, 2020) [广东新港兴混凝土有限公司和解案].

[61] Enterprise Bankruptcy Law of the People's Republic of China (2006), Art. 14.

[62] Ibid, Art. 16

[63] Ibid, Art. 15.

[64] Ibid, Arts. 31 and 33.

[65] Ibid, Arts. 75 and 77.

[66] Interview with a senior partner of a leading law firm in China (February 23, 2023).

[67] L. Shuguang and W. Zuofa, The Gap between Expectation of Legislation and Judicial Practice and Its Resolution: Empirical Analysis of Bankruptcy Law's Three-years Implementation (2011) 2 *Chinese University of Political Science and Law Review* [中国政法大学学报] 58–79.

incentives to rescue the firm and yield interest for weaker parties. They could have exercised their priority rights and got repaid first before unsecured creditors, rather than bearing the risk of resuming the company's operation. But for the remaining thousands of unsecured creditors and weaker parties, the insolvency procedure represents the form of justice they expect from courts despite the fact that the average haircut of creditors made during the insolvency procedure in China is still as high as 60 or 70 percent[68]

Furthermore, the insolvency procedure provides a vital platform for courts to fulfill the government's policy – to minimize the economic impact caused by these disputes. Once the insolvency procedure begins, for example, courts can cancel all existing injunctions over debtor's property imposed by previous litigation.[69] Injunctions and subsequent enforcement actions (such as the sale of machinery) could disrupt the process and result in an increase in unemployment, which could subsequently result in social unrest. Unsurprisingly, in many selected precedents by Chinese high courts, judges always emphasized the mandate of "making business as usual" after switching to insolvency and thereby lifted the injunctions that had frozen the firms' assets and bank accounts, stopped salary payments, and ceased business operations.[70]

Notably, the government and the Party play a vital role in insolvency procedures. While court documents have recorded the presence of Party officials in various meetings, the summary of selected precedents have also emphasized their participation and contribution. Interestingly, the government and Party involvement does not serve to diminish the courts' authority; on the contrary, it helps to empower the courts. The local officials and party cadres issue orders to require other agencies, SOEs, and banks to disclose information that courts and reorganization managers (who are usually lawyers) demand.[71] Occasionally, they even pay service fees to law firms to deal with SOE insolvency cases.[72]

It should be noted that plaintiffs, weaker parties, judges, and lawyers always welcome the Party and government's involvement, instead of worrying about a lack of judicial independence. In some cases, lawyers would not have taken the cases if the government had not promised to be involved.[73] That being said, governmental

[68] H. X. Chian and J. Y. An, Choices, Mechanisms, Economic Efficiency, and Legal Grounds of Listing Companies' Bankruptcy and Reorganization (2006) 7 *Management World* 130 [何旭强, 周业安, 上市公司破产和重整的选择, 机制、经济效率及法律基础].

[69] Enterprise Bankruptcy Law of the People's Republic of China (2006), Art. 19.

[70] People's Supreme Court of China, Selected Cases on Ensuring the Resumption of Operations by Companies.

[71] Interview with a senior partner of a leading law firm in China (February 13, 2023).

[72] Usually, this is about what are commonly called "zombie SOEs," which refer to SOEs that ceased to operate prior to the pandemic. The State-owned Assets Supervision and Administration Commission (SASAC) of the State Council required these zombie SOEs to go into insolvency procedure as well. While the government paid the service fees, law firms charged only minimal service fees as such cases are effectively deemed as pro bono services.

[73] Note 66.

officials and Party cadres do not intervene directly in actual administration of insolvency and reorganization. Rather, they let courts and lawyers run the insolvency procedure for a strategic reason: the insolvency procedure led by judges and lawyers can contain and dissolve the tensions of social unrest. Judicialization of social unrest and regional financial crises can protect local officials and Party cadres from direct pressure that they could have potentially encountered in dealing with weaker parties directly.

4.5.2 *Social Unrest and Contract Disputes*

Inequality could be one of the underlying causes of massive numbers of contract disputes and resulting social unrest in China. It concerns distributive justice and the performance of the government. A shared feature of cases dealt with under the insolvency approach is their large scale. One real estate dispute could involve several thousand, or up to more than ten thousand, home buyers. One of the law firms I interviewed has more than twenty such cases ongoing at any one point in time. The largest cases involve consolidated insolvencies, where the parent company is amalgamated with several dozens of "zombie subsidiaries" that have ceased operations even prior to the pandemic.

The insolvency approach is strategic in that it offers a sense of entitlement to comfort weaker parties. Each phase of the insolvency procedure offers a symbolic milestone that creditors' rights seem to have been further confirmed and protected by the legal system. With creditors' anger being channeled into the insolvency procedure, the government will not have to undergo the difficulty of dealing with thousands of angry creditors chanting in front of government buildings. At the end of the day, however, courts cannot generate revenues to fulfill the legal claims of creditors and other weaker parties. A certificate of credit has little meaning if such credit cannot be honored by debtors eventually. Nonetheless, the lengthy insolvency procedure can help to allay tensions with most of the angry protesting creditors. Once their anger has been channeled into an insolvency procedure, they would be amenable to following the courts' order to proceed. "Eventually, they will come to realize that they will not be able to get their money back," said a bankruptcy lawyer.[74]

Nonetheless, courts indeed tried to address weaker parties' grievances and find a way to protect their rights. Judges have leveraged their discretion and authority to persuade secured creditors to give up some of their legal entitlement for the benefit of weaker parties. Sometimes, judges would impose real pressure. Courts would refuse to approve secured creditors' motion to sell debtors' assets or other collateral if they do not yield to demands of weaker parties.[75] Courts could also refuse to remove

[74] Interview with a Chinese bankruptcy lawyer (February 1, 2023).
[75] Note 66.

injunction over the pledged assets to prevent secured creditors from exercising their security interests. Sometimes, courts have resorted to moral persuasion. For example, judges often emphasize in their judgments a Chinese saying that "we should share hardship together during difficult time" (共體時艱), which again represents a communitarian, collective value about social responsibility and risk-sharing.

The government is aware that the success of this approach requires institutional capacity of the courts and legal professionals. They have empowered and collaborated with courts and lawyers involved in facilitating the process, but they would never put themselves forward to lead the procedure directly. As a bankruptcy lawyer described, he spent more time in comforting those anxious small creditors than in dealing with legal issues, and still received phone calls from them from time to time even after he left the firm.[76] Nonetheless, the government has acted quite legalistically in that it required such disputes to be resolved through legal processes. That being said, it has solved the problem of inequality by circumventing contract terms, which is far from legalistic behavior.

4.5.3 *Limitations*

The courts and governments do manage to address inequality through the insolvency approach, but whether this approach is effective remains a separate issue. It is common for weaker parties, who are usually unsecured creditors, to discover that their credits were not protected by any security interest. On the contrary, power players such as financial institutions, formal or informal, and other guarantors have obtained priority rights at the early stage of transactions. Judges could put pressure on secured creditors to relinquish their priority rights but only to a limited extent. Consequently, through the insolvency procedure, unsecured creditors, common shareholders, and other weaker parties might secure but not materialize their rights eventually. In a case that involves a shadow bank defaulting on its contracts with large numbers of depositors, the creditors settled the disputes by accepting a 70 percent haircut after months of protests that compelled the government to intervene. Although the government's direct intervention accounted for the successful settlement, creditors were still unable to receive any of their scheduled payments.[77]

Under the insolvency approach, the main challenge of tackling inequality in contract disputes is the complexity of transactions. Any transaction involves multiple contracts that construct various degrees of priority rights and involve a large number

[76] Note 74.

[77] Interview with a lawyer based in Hong Kong who has close contact with victims of financial product default in China (December 12, 2022).

of institutional and individual stakeholders. Some of those contracts could be viewed as unfair, but most of them are in line with market practices and are not in dispute in the proceedings. For instance, when a real estate developer fails to perform its contracts with home buyers, the mortgage contracts between home buyers and their banks nonetheless remain valid. Also, banks that have offered lines of credit to the real estate developer can also validly claim their priority rights over other unsecured creditors as their contracts are valid. Even though Chinese judges have engaged in insolvency procedures to circumvent some unfair contract terms, they still cannot address inequality in a fundamental way, unless they can revise other contractual agreements beyond the original scope of dispute. However, that would go too far and affect the core function of contracts in market transactions. At the end of the day, contract law heterodoxy as well as ultra-heterodoxy, even justifiable, seems to be able to play only a complementary role.

Under the insolvency approach, inequality would be addressed but seems to be an ancillary benefit compared to the state's main objective of preventing social unrest. Due to its strategic considerations, the government behaves legalistically in terms of the insolvency procedure. The judicial system has proved to be an effective tool to tackle the social and political consequences of inequality, but not necessarily the economic consequences per se. In fact, China's approach is not uncommon. During its authoritarian era, Taiwan relied on its judicial system to dissolve social and economic tensions, while Japan's courts have also worked with the executive branch to identify and solve disputes that would disrupt social and economic order.[78] Additionally, at its nascent stages of economic development, Singapore created an illiberal welfare state and had lawyers step in to reduce the risk of violent protests and channel tensions into the judicial system.[79] Similarly, during 1997 Asian financial crisis, law firms in Korea also played a vital role and benefited significantly from a rapid increase in insolvency cases.[80] However, economic inequality remains an issue in both Singapore and South Korea today, although the trickle-down effects of economic development together with their mature legal systems have largely prevented any disruptive consequences of inequality from coming to the fore. Without political determination and broader policies, the judiciary could only address the tip of the iceberg.

[78] W. Chen and H. Fu (eds.), *Authoritarian Legality in Asia* (Cambridge: Cambridge University Press, 2020); W. Chen, Twins of Opposites: Why China Will Not Follow Taiwan's Model of Rule of Law Transition Toward Democracy (2018) 66 *The American Journal of Comparative Law* 481–535; Upham, Reflection on the Rule of Law; Haley, Constitutional Adjudication in Japan.

[79] Y. Dezalay and B. Garth, *Asian Legal Revivals: Lawyers in the Shadow of Empire* (Chicago: University of Chicago Press, 2010), pp. 117–31, pp. 247–62, p. 251.

[80] K. S. Hyun, The Democratization and Internationalization of the Korean Legal Field, in Y. Dezalay and B. Garth (eds.), *Lawyers and the Rule of Law in an Era of Globalization* (Oxfordshire: Routledge, 2011), pp. 223–46, pp. 223–24.

4.6 ULTRA-HETERODOX MODE THREE: THE MACROPRUDENTIAL APPROACH

The last approach is designed to deal with contract disputes that may trigger the most undesirable scenario for the Chinese government during an economic downturn such as the pandemic financial crisis. Here, the main risk is not social unrest, but the systemic risk inherent in the financial system. Such systemic risk arises from how intertwined these entities are with the wider Chinese financial ecosystem, including entities such as real estate developers, non-bank financial institutions, and large banks. The macroprudential approach is thus focused on such institutions. Inequality problems were exposed by such types of contract disputes, and hence petitions and protests by contract parties also took place.

Considering the larger impacts, the government and Party would take the lead in containing the crisis instead of relying on lengthy judicial proceedings to borrow time and dissolve social tensions. The solution is still constructed in a legal way, although courts are relegated to a more secondary role. For example, after relevant parties and the governmental agencies have reached a solution, usually involving corporate restructuring, haircut of debts, additional loans and bailout, and creations of trust, they would register their solutions as a "reorganization by agreement" with the court in the insolvency procedure.

4.6.1 *Systemic Risks Triggered by Contract Disputes*

In China, the most serious problem during the pandemic, other than the pandemic per se, was likely the regional financial crises. Before the pandemic, mounting debts of local governments, prevailing shadow banking, real estate bubbles, and speculative and wasteful investments had already constituted the perfect recipe for crises if a trigger happened. The pandemic, together with China's long lockdown, added more pressure to China's banking and financial system, which saw rapidly increasing bad loans, quick depreciation of Chinese yuan, and disruptions to funding in the interbank market.[81] Such conditions could result in a liquidity mismatch and bank run, which could be further amplified by existing contract terms such as cross-default provisions and escalate into a systemic crisis. Since the pandemic, observers have been paying close attention to the situation to assess the possibility of a financial crisis.

Financial crises are usually caused by systemic risks triggered by a series of contract defaults. Unlike the risk of individual entities that can be contained largely through legal and economic measures, such as mandatory disclosure, systemic risks are usually triggered by one entity in distress and followed by domino effects that

[81] N. Borst, Has Covid-19 Led to Financial Instability in China?, *Seafarer* (April 2020).

would bring down other financially healthy entities.[82] The transmission of such risks is possible due to the highly interconnected and interdependent nature of modern financial systems. One firms' liquidity shortage can be transmitted to other financially healthy firms through preexisting legal arrangements such as cross-guarantees, cross-default, and cross-shareholding. China is no different in this regard.[83] Due to the potential for the transmission of systemic risk, these domino effects have to be stopped through a coordinated and swift intervention by state agencies, regulators, and stakeholders before a systemic financial crisis breaks out.

Systemic risks of the financial system did not attract sufficient attention of scholars and regulators until after the 2008 global financial crisis. Thereafter, macroprudential policies have been developed to address systemic risks inherent to the markets and financial system, as opposed to micro-prudential polices popular prior to 2008, which focus on risks of individual market players and use legal measures such as corporate governance and disclosure requirement under securities regulations to prevent such risks. China is a latecomer to such policies but appears to have quickly adapted to the existing literature set out in macroprudential policy discussions. Compared to the mediation and insolvency approaches, the government, the Party, and the courts have adopted the macroprudential policy to prevent financial crisis during the pandemic.[84] This approach also involves multiple stakeholders and regulators in the process and operates within and beyond the judicial system. I call it "the macroprudential approach."

While the insolvency procedure aims to prevent social unrest as a result of unequal contractual relationships, the macroprudential approach is aimed at dealing with broader financial consequences. Three other differences between insolvency and macroprudential approaches exist. To begin with, the main difference lies in the length of time to solve the contract disputes. While the insolvency approach utilizes a lengthy legal procedure to mitigate the tension among massive numbers of unhappy creditors, the macroprudential approach seeks to solve the disputes as soon as possible to the extent that the transmission of systemic risks could be stopped.

The second difference is the role of the government and the Party. In the insolvency approach, the Party, together with relevant departments of local governments such as the land and accounting bureaus, operates behind the scenes and demands courts and lawyers take the frontline in dealing with unhappy creditors. In contrast, the macroprudential approach involves the state putting itself forward and actively

[82] W. Chen, China's Long March to Dismantling the Financial Great Wall: Renminbi's Internationalization, Systemic Risks and Macro-prudential Regulations, in A. Anand (ed.), *Systemic Risk, Institutional Design and the Regulation of Financial Markets* (Oxford: Oxford University Press, 2016), pp. 143–74.

[83] W. Chen, Lost in Internationalization: The Rise of China's Renminbi, Macroprudential Policy, and Global Impacts (2018) 21 *Journal of International Economic Law* 31–66.

[84] People's Bank of China, Guidelines on Macroprudential Policy (Temporary), The State Council of the People's Republic of China (January 1, 2022).

leading the process, with courts playing a complementary role. As time is of essence, the state leverages its power over all stakeholders to solve disputes during a brief window of time before any domino effect could take root.

The last difference is the respective legal instruments each approach engages with. The insolvency approach uses the reorganization process built into the insolvency procedure to protect the poor by circumventing contract terms altogether. In comparison, the macroprudential approach moves beyond the insolvency procedure, using multiple legal tools including renegotiation, contractual agreements, reorganization, and trust, together with financial bailouts, to address the issues. But, eventually, these multi-faceted solutions, once finalized, would be formulated as a legal scheme so that courts can follow up and help out with implementation. In any case, similar to the insolvency approach, the original contract terms were bypassed or amended in order to address inequality and its impacts.

4.6.2 *Macroprudential Policy in Law*

China started its adoption of macroprudential policies fairly late; however, now, courts have been asked to play a more involved role in implementing macroprudential policies. Specifically, macroprudential policies in the areas of financial regulation usually require counter-cyclical measures to prevent economic bubbles and restrain banks from over-lending. Inter-agency monitoring and information sharing are crucial to provide a holistic assessment of potential systemic risks.[85]

Not only are Chinese courts recognized as a key agency for enforcing macroprudential policy but also Chinese contract law plays a crucial tool in this regard. In 2021, the People's Supreme Court issued guidance stating that a contract should be nullified if its primary purpose is to circumvent China's macroprudential policy.[86] In 2023, a Supreme Court judge further emphasized that a contract contradicting the macroprudential policy could be deemed in violation of social morals and public order under Chinese contract law, leading to its nullity.[87] Additionally, judges have the authority to adjudicate cases based on administrative orders or directives related to macroprudential policy and other financial market regulations, even in the absence of specific applicable laws.[88]

At the moment, the macroprudential approach remains tied with the insolvency procedure but subject to a very different dynamic. For example, in a reorganization

[85] Chen, Lost in Internationalization.

[86] People's Supreme Court, 'Opinion about Streamlining Lawsuits that Cover Illegal Purposes' [关于深入开展虚假诉讼整治工作的意见] No. 281 (2021).

[87] H. Zhang and S. S. Wu, The Direction for Adjudicating Financial Disputes? Highlights of Financial Law Adjudication of National Courts [金融纠纷审判何处去? —全国法院金融审判会议热点探讨], *AnJie Broad* (March 2, 2023). Also, People's Supreme Court, Notice on the Summary of the Conference on Civil and Commercial Adjudication by National Courts ["全国法院民商事审判工作会议纪要"的通知], No. 254 (November 8, 2019).

[88] Zhang and Wu, The Direction for Adjudicating Financial Disputes?.

case in Tianjin City, a large construction company fell into distress and triggered a chain of defaults.[89] The city government as well as the local Party officials quickly intervened to prevent further complications. They took the leading role and gathered more than forty banks to discuss a possible reorganization plan for the company. Government agencies and Party officials that were involved included those from the local branches of People's Bank of China, Chinese Banking Regulation Commission, City Land Bureau, City Natural Resources Bureau, City Development and Reform Bureau, Tax Bureau, Accounting Bureau, Electricity and Power Bureau, and the City Legal Office. Various priority rights held by pledgees and guarantees were rearranged and a trustee was appointed to manage valuable assets and execute the reorganization plan. From the beginning the government invited legal advisers to join but not the courts. Only when all parties had reached a settlement agreement were the courts involved, after the company registered their plan as a "reorganization by agreement" under the Enterprise Insolvency Law.[90] In this way, the courts can monitor and help enforce the settlement plan.

It is understandable that the government leads the courts in this process. What the government and courts did in such type of cases are in line with what the macroprudential policy suggests. The government exerts its power to order other stakeholders, such as state-owned banks, to act in a certain way to preserve the markets. Despite scant discussions before, Chinese regulators were swift in adapting and implementing macroprudential policy best practices during the pandemic. Most notably, Beijing required the courts to collaborate and carry out macroprudential policies as well. In 2021, the emphasis on the extensive coordination between the courts and regulators was spelled out in the language of the 2021 Central Economic Work Conference:[91] "combining the responsibilities of local authorities, financial regulatory authorities, industry authorities and other parties, and strengthening the self-rescue responsibility of enterprises."[92] The necessity of such coordination was also spelled out in the Guidelines on Macro-Prudential Policies ("Guidelines") which emphasize intra-branch coordination mechanisms.[93] Unlike in Western

[89] Reorganization of Tianjin Municipal Construction Group.

[90] Note 66.

[91] Fangda Partners, The Annual Report of Financial Law Compliance [金融法律监管年度报告] (2022).

[92] In 2021, for example, the China Securities Regulation Commission (CSRC) established a working group to crack down on illegal capital markets activity. This group consisted of the Ministry of Public Security, the Supreme Court, and the Supreme Procuratorate. The Supreme Procuratorate also set up a procuratorial office branch in the CSRC. The cases investigated by this working group include corporate entities involved in large-scale market manipulation. Additionally, the court's reliance on the preceding administrative procedure was abolished to give the courts greater freedom to reach their own judgments and not to be bound by a predecision of the CSRC. See General Office of the Central Committee of the CPC and the General Office of the State Council, Opinions on Strictly Cracking Down on Securities-related Illegal Activities [关于依法从严打击证券违法活动的意见] (2021).

[93] Note 84, Art. 34.

countries where courts are independent of the implementation of the macroprudential policy, the Guidelines emphasize the courts' role as the primary entity for adjudicating illegal activities in the capital market and underscore the importance of collaboration between the courts and the leading regulators of macroprudential policy.[94]

The involvement of courts is quite unique compared to the practices in the United Kingdom and the United States. In the United Kingdom, the Bank of England is assigned full responsibility for macroprudential policy. Within the Bank, the Financial Policy Committee, chaired by the Governor, is the main body charged with identifying, monitoring, and addressing risks to the financial system as a whole.[95] In the United States, a Financial Stability Oversight Council has been formed as a result of the Dodd-Frank Act, comprising all US financial regulators and chaired by the Secretary of the Treasury.[96] In both the United Kingdom and the United States, courts are not included in this regulatory body, nor do they play any role in implementing these regulations. In China, by contrast, courts are actively involved in macroprudential policies. This indicates that courts are deemed as part of the government body and expected to share the administrative workload. Separation of powers is not the norm.

Under the macroprudential approach, the original contract terms only serve as a reference point for the negotiation among all parties to settle the reorganization plan for the company in default. Contracts are selectively enforced to the extent that any enforcement or non-enforcement should not worsen the financial crisis and instead should be readjusted for the sake of restoring the financial order. This selective enforcement approach is not unprecedented. During the 2008 global financial crisis, to preserve the market and halt the financial crisis, the Federal Reserve discharged several selected financial firms from their contractual obligations as stringent enforcement would have brought down the whole financial system. Such a selection is based on the value of individual firms for preserving the financial system.[97] Those that constituted the core of the financial system were not only freed from their contractual obligations but also received governmental bailouts.[98] Similar to China's macroprudential approach here, these decisions were made by the US government while courts only played a secondary role.

4.6.3 *Government–Court Collaboration*

More generally, in addition to the courts' involvement in macroprudential policy implementation, China has been promoting a model called "Government–Court

[94] Ibid., Art. 12.
[95] United Kingdom, Stationary Office, The Financial Services Bill: The Financial Policy Committee's Macro-Prudential Tools (2012).
[96] European Central Bank, Financial Stability Review (December 2010).
[97] K. Pistor, A Legal Theory of Finance (2013) 41 *Journal of Comparative Economics* 315–30.
[98] Ibid.

Collaboration" (府院聯動模式) since 2021. Local governments and courts have issued guidelines and organized workshops to promote this model. The People's Supreme Court of China has also been evolving its own judicial policies to accommodate and implement party-related pandemic policies.[99] The idea of this model is to have courts work with local governments to preemptively solve business disputes which have been identified as potentially having wider impacts on local social order and economic markets. On the one hand, the government and the Party facilitate the legal proceeding. On the other, the solution should be framed legalistically and enforced by the court. This model is derived from administrative law principles immediately prior to the pandemic, with the purpose of demanding related governmental agencies to participate in the procedure. Subsequently, during the pandemic, the model was expanded, as discussed herein.

In cases that may trigger a financial crisis, local governments have strong incentives to proactively participate in legal proceedings. This is because large companies which conduct operations in the localities usually have significantly contributed to job markets and tax revenues, serving as an indicator of good performance and governance.[100] Contracts involved in such cases, like those dealt with by the other two approaches, involve many economically weak parties. Fixed terms were not allowed for negotiations before parties signed the contracts. But, once disputes arise out of these types of contracts, the scale of economic impacts is wider, the number of parties involved larger, and the financial and political risks higher. Interestingly, although local officials do not want the formal legal proceedings to prolong the crisis, they nonetheless appreciate the value of the law in standardizing and institutionalizing the crisis management process.

As a result, courts and local governments began to "institutionalize and normalize this model" and vowed to "improve communication and collaboration with local party secretaries and government agencies" and jointly solve disputes based on "the market principle and legalistic approach."[101] In early 2023, for example, Shanxi Provincial Governments enacted "Guidance for Government–Court Collaboration Mechanism for Insolvency Cases," which demands various collaboration mechanisms between district governments and courts to be created, including joint task forces, regular meetings, information sharing, preemptive monitoring, assessment of corporate risks, and proposed settlement proposition.[102]

[99] People's Supreme Court of China, Guidelines on Proper Trial of Civil and Commercial Cases.

[100] Shuguang and Zuofa, The Gap between Expectation of Legislation and Judicial Practice and its Resolution.

[101] Y. Shan, Heilongjang Fonglin District Court Explored New Mechanisms for Bankruptcy Practices through Government-Courts Collaboration [黑龙江丰林县法院, 积极推动"府院联动"探索破产审判新机制], *China Court Org.* (November 30, 2022).

[102] Shanxi People's Government, Enterprise Bankruptcy and the Creation of Government–Court Collaboration Mechanisms [企业破产处置建立府院联动机制], *Datong Municipal People's Government Portal* (January 6, 2023).

Given China's political economy, the government's direct involvement is arguably inevitable and even necessary for tackling these problems. Now, the involvement has been formalized by this government–court collaboration model. In the insolvency process, secured creditors and preferred shareholders (most are rich and powerful banks) have a higher claim on the firm's assets than unsecured creditors and common shareholders, respectively, and therefore they have fewer incentives to reorganize the firm in default. They do not necessarily benefit from reorganization but have to bear the risks of it. As such, renegotiation about contract terms cannot be completed through market mechanisms, as such mechanisms favor the prevailing power players.[103] It requires pressure from the government to press these priority rights holders to give in and work with other normal creditors and the management team, as judges have little bargaining power in the face of powerful market players.

While the legal procedure and contract terms are largely bypassed, both courts and the government tackle the corporate problems legalistically by framing it in the context of legal rules and frameworks. The government and Party take the leading role in the macro-prudential approach, but eventually they would frame the solutions in a legalistic way. For instance, a trust is usually created to hold the firms' assets, with an appointed trustee to execute the reorganization plan under the courts' monitoring. In short, it serves the central government's interests for the courts to stick to established insolvency and legal procedures as it promotes social stability and order.

4.7 NEGOTIATED LEGALITY

The fact that these various approaches work in China offers us an opportunity to observe a peculiar perception of legality in China, which I name "negotiated legality." The perception of legality is closely associated with the legitimacy of the state and courts. The Chinese government's political legitimacy does not lie in any bottom-up democratic procedure, but rather in its substantive performance.[104] Political scientists have empirically demonstrated that, in China as well as in other Asian countries, both democratic and authoritarian, citizens' perceptions about "democracy" and "accountability" concerns mainly economic development rather than human rights, policymaking participation, or democratic election, all of which instead reflect the perception of democracy and accountability in the West.[105] In this

[103] Shuguang and Zuofa, The Gap between Expectation of Legislation and Judicial Practice and Its Resolution, 68.

[104] W. Chang, *In Search of the Way: Legal Philosophy of the Classic Chinese Thinkers* (Edinburgh: Edinburgh University Press, 2016); F. Fukuyama, *Political Order and Political Decay: From the Industrial Revolution to the Globalization of Democracy* (New York: Farrar, Straus and Giroux, 2014); S. Cook, The Debate over Coercive Rulership and the "Human Way" in Light of Recently Excavated Warring States Texts (2004) 64 *Harvard Journal of Asiatic Studies* 399–440.

[105] M. H. Huang, Cognitive Involvement and Democratic Understanding, in T. J. Cheng and Y. H. Chu (eds.), *Routledge Handbook of Democratization in East Asia* (Oxfordshire: Routledge, 2017), pp. 219–313; P. Goedde, The Making of Public Interest Law in South

regard, it is not a surprise that many Chinese people view China as a democracy as long as they are economically better off. This strange phenomenon existed in Taiwan, Singapore, and South Korea during their authoritarian era too.[106]

Such understanding of accountability therefore exerts pressure on the Chinese government to deliver good performance. In courts, people do not necessarily trust the judicial system but may have trust in individual judges and exert similar pressure and expectation. When inequality issues arise in contract disputes, good performance is about the delivery of distributive justice. Otherwise, the problems of unfairness, inequality, social unrest, and financial crisis will directly harm the legitimacy of the government and the Party, without resorting to any periodic election. On the other hand, the Party-state's use of courts and the legal system to solve disputes also constitute an alternative form of bottom-up accountability in that people are willing to participate in legal proceedings to voice their concerns and the government in turn responds through the proceedings to address their grievances. A resilient authoritarian regime cannot rely solely on top-down coercion but has to create some bottom-up mechanisms to strengthen its legitimacy.

Negotiated legality in China is unique in that all stakeholders including the courts subject legality to negotiations during contract enforcement. As shown in my case studies, dispute resolution is more about delivering substantive justice, even just symbolically, than determining winners and losers according to the law of contract. Judges are more concerned about seeing the final resolution of a dispute where parties are satisfied with the outcome. Legality is not determined according to the law and existing contract terms fixed during contract formation. Rather, legality is determined through subsequent negotiations during the contract enforcement process. Examples of how substantive justice is promoted occurs across all three ultra-heterodox modes, where all parties' (including dominant market players and weaker individual creditors) reasonable expectations are safeguarded, to a degree deemed appropriate, through court-led renegotiation about risks and losses sharing. Original contract terms serve merely as a starting point for all parties to renegotiate risk distribution and damage-sharing. All stakeholders share the same understanding of legality, and hence those involved in negotiations are not limited to contract parties but also involve many non-contract parties.

Negotiated legality contrasts with the concept of "relational contract," which describes how contract parties could rely on the reputation mechanism and reciprocity norms to form and enforce their informal contracts, and thereby maintains a long-term relation in a cost-efficient fashion.[107] The process usually involves

Korea via the Institutional Discourses of Minbyeon, PSPD and Gonggam, in H. Yang (ed.), *Law and Society in Korea* (Cheltenham: Edward Elgar, 2013), pp. 131–49.

[106] See, e.g, Huang, Cognitive Involvement and Democratic Understanding.

[107] S. Johnson et al., Courts and Relational Contracts (2002) 18 *Journal of Law, Economics, & Organization* 221–77; L. Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry (1992) 21 *The Journal of Legal Studies* 115–57; M. J.

frequent negotiation between contract parties due to the nature of their incomplete contracts. What I unveil in this essay offers a different picture. Negotiation is not just a process for maintaining a long-term relationship between contract parties. Much more fundamentally, it demonstrates a continuing process to determine legality *ex post*.

While the operation of both negotiated legality and relational contracts primarily takes place during contract enforcement, the mechanisms that possibly drive negotiation appear differently through the lens of negotiated legality. My case studies show that, without the Party-state's intervention, negotiations between strong and weaker parties would not necessarily happen even though a long-term relationship exists. In the case of extremely unequal contracts, stronger parties with priority rights (such as banks and secured creditors), especially those based on other valid contracts not in dispute, do not have the incentive to negotiate. Many of those contracts are also the products of long-term relationships, for example, contracts about long-term supply of manufacturing materials, financial credit line, or business alliances. Even if those stronger parties such as secured creditors negotiate with their underprivileged counterparties, such private negotiation would allow them to largely keep their market advantages by sticking to the contract terms. Inequality would remain and even be strengthened by the law to the extent the validity of existing contract terms is upheld.[108]

As such, it requires a third-party to intervene in this unequal contractual relationship rather than rely on markets or private negotiation. In other words, relational contracts might correctly account for the reality of contract enforcement in some countries, but they also lead to inequality that requires a different approach to address. Considering the current political economy in China, this unfair setting arguably has to be brokered by the government, together with courts. The Party-state is the main dominant power that has sufficient political and legal clout over those stronger parties in contractual relationships. To judges and Party-state officials, the wide discretion delegated by Chinese contract law is still not good enough, so they resort to the more drastic approaches I have identified to circumvent the contract terms in dispute.

Moreover, while the relational contract literature suggests that the self-interest of the parties drives negotiations, the negotiations under the three ultra-heterodox modes in China are rather policy-driven through significant external pressure from the government and courts. Through the exercise of legal discretion, moral persuasion, or sheer power, the judges and the Party-state pressed creditors, and sometimes debtors too, to concede. These negotiations are about the state actors' efforts to prevent market disruption, social unrest, and financial crisis, which private contract parties are not particularly concerned about. Contract parties do not necessarily

Trebilcock and J. Leng, The Role of Formal Contract Law and Enforcement in Economic Development (2006) 92 *Virginia Law Review* 1517–80.

[108] See K. Pistor, *The Code of Capital: How the Law Creates Wealth and Inequality* (Princeton: Princeton University Press, 2019).

benefit from such negotiations either; for example, secured creditors would be compelled by judges to give up their priority rights. Most likely, their counterparties alleging unfair contracts would not gain significantly from such negotiations either. Through insolvency, the weaker parties may receive certificates of credit, but such certificates are not cash and most likely would not be redeemed eventually. Their money was long gone through complex and wasteful networks of speculation activities long before the disputes arose. At the end of the day, they would come to realize that credit certificates and negotiation outcomes only offer a symbolic and emotional comfort.[109] Arguably, the main beneficiaries are those who benefit from the stabilization policies that drive the ultra-heterodox approaches, such as the community at large, government agencies, and, eventually, the Party-state, all of which demand social and economic stability as the paramount objective.

Negotiated legality works in China because of the country's political economy, culture, and economic efficiency calculation. To begin with, the strong Party-state, dominant both in public and private sectors, has the capacity to intervene in private contractual relationships. Stakeholders either welcome or cannot reject such intervention. Secondly, there exist various communitarian norms for judges to employ. In Western-style democracy, justice will be delivered through procedural formalism, with injustice generally stemming from not adhering to the procedures or terms agreed upon. In contrast, negotiated legality treats the agreed contract terms at issue merely as a reference point for subsequent negotiations during contract enforcement. Contract parties in China, regardless of their status in a contractual relationship, do share a communitarian understanding of liability and responsibility, such as "going through hardship together."[110] Judges believe such norms can solve contract disputes in cases concerning inequality better than the law of contract. Lastly, negotiated legality could be more cost efficient in emerging markets in that contract parties can postpone the costly risk identification process and lengthy negotiation about risk allocation from the contract formation phase to enforcement stage. In this way, the initial stage of deal making could be faster and less costly. From the Party-state's perspective, it could be efficient too if they delegate to local participants and market actors the power to clarify and debate about legality through their market practices and concretize some abstract legal doctrines. The Party-state can always intervene at a later point when necessary. In short, negotiated legality, which underlies various communitarian norms, are not just a cultural phenomenon but also closely tied with the country's political economy and cost-benefit calculation.

[109] This is the view often expressed by insolvency lawyers I interviewed.

[110] Literature on the communitarian norms in China is scant but has pointed out such communitarian norms in the field of torts, constitutional law, and property law. As shown in this essay, this communitarian view exists in the area of contract law too. See, e.g., B. Liebman, 'Leniency in Chinese Criminal Law? Everyday Justice in Henan' (2015) 33 *Berkeley Journal of International Law* 153–222; T. Li-ann, 'Varieties of Constitutionalism in Asia' (2021) 16 *Asian Journal of Comparative Law* 285–310; Stern et al., Liability beyond Law.

It remains to be observed whether China's statist model will be sustainable in the long-term, although in the short-term it seems justifiable by some positive outcomes. Within the legal academia in China, criticism against such government involvement is not uncommon.[111] Negotiated legality offers room for policy intervention and serves as a mechanism to correct the failure of market mechanisms to address inequality. But it is also vulnerable for manipulation under authoritarianism and populism.

4.8 CONCLUSION

A civil law system comes closer to contract law heterodoxy in preserving room to deal with inequality through various doctrines that enable judges to nullify contracts in violation of communitarian values such as social morals and public order. Such doctrines indicate that the state preserves the authority to correct unfairness and inequality in certain contracts in dispute, although as a last resort. In China, as well as elsewhere, the pandemic has unveiled economic inequality in many contractual agreements. Have Chinese judges increased their use of these codified doctrines to correct contract inequality accordingly? Oddly, the number of cases in reliance to those doctrines did not increase during the pandemic; rather, it seemed to drop significantly.[112]

Chinese judges did not seem to use these doctrines under their contract law at a time when most extensive inequality had been exposed in contract disputes. Why not? My case study shows that Chinese judges endorse the spirit of the contract law heterodoxy, but do not think it is good enough to address inequality. Rather, they have developed three alternative approaches, depending on the merit and impact of various cases, to deal with contract disputes that are of inequality nature: the mediation, insolvency, and macro-prudential approaches. Interestingly, judicial independence is never a concern. As in all three approaches, the state and courts collaborate closely and work hand-in-hand to solve disputes and weaker parties welcome such intervention.

There are several takeaways from Chinese practices. First, the idea of contract law heterodoxy is valuable, but its effectiveness may be limited. Most transactions have to be constructed by multiple contracts, such as real estate transactions that could involve purchase agreements, mortgage agreements, guarantee agreements, pledge

[111] Shuguang and Zuofa, The Gap between Expectation of Legislation and Judicial Practice and Its Resolution.

[112] According to China Judgments Online, the judicial database maintained by the People's Supreme Court of China, the number of cases adjudicated based on the "change in circumstance" clause dropped by 34 percent during the pandemic (between January 2000 and December 2022), compared to the same period of time prior to the pandemic (between January 2017 and December 2019). However, it should be noted that it is unclear whether such statistics of reported cases are complete and correct.

agreements, and other understandings when necessary. Inequality, when existing, does not necessarily result from only the specific contract in dispute, but rather from other related contracts too between third parties and the parties in dispute. The negative impact of each contract varies at different degrees and what is not justifiable is the accumulative effect of inequality caused by multiple contracts, including those not in dispute (yet) and thus not subject to judicial scrutiny. Unless courts are allowed to further conduct a holistic review and correct some terms of other contracts, they cannot address inequality effectively.

Second, the role of the government remains vital in addressing inequality, although the specific Chinese model is difficult to replicate. Driven by concerns about social stability, Chinese courts seem more adamant than courts of other countries about addressing inequality, instead of letting tax or fiscal policies deal with inequality as opponents to contract law heterodoxy suggest. If courts in a democracy try to mirror the approach of Chinese courts, however, they would face severe challenges against its legitimacy as contract freedom and individual autonomy would have been seriously compromised. Chinese courts do not have to face legitimacy challenges from either the executive or the legislative branches, because they are viewed as an integral part of the state apparatus. By endorsing and empowering the courts, the government prevents inequality issues from escalating into social unrest and financial crises. The general public supports the government's intervention because of its clout over those strong parties in such unfair contract relationships. With support, courts could extensively apply communitarian norms, such as "going through hardship together," "collective risk sharing," or "be sympathetic to your counter-party," to demand stronger parties to negotiate and compromise. This process is fluid and smooth due to the peculiar perception of legality in China – negotiated legality.

The last takeaway is centered around the interesting finding that the Chinese government has framed its actions legalistically, despite bypassing legal procedure and contract terms, and is adamant that the courts and legal professionals play a key role in solving those disputes concerning inequality. In contrast to the general impression that the Chinese Party-state acts against the law, my findings reveal more nuances about the dynamics of China's legal system development and shed light on how the Party-state treats legality strategically.[113] Apparently, even as an authoritarian regime, the Chinese state has come to appreciate the institutionalization of combating inequality through the legal system. Also, in its view, existing institutional settings and doctrines do not seem sufficient; rather they sometimes strengthen the unequal status quo. Such perception leads to the ultra-heterodox approach the Chinese courts have developed, together with the state's further intervention in

[113] C. Minzner, China's Turn against Law (2011) 59 *The American Journal of Comparative Law* 935–84. C.f. T. Zhang and T. Ginsburg, China's Turn toward Law (2019) 59 *Virginia Journal of International Law* 306–89.

dispute resolution. Their drastic approaches might not be replicated elsewhere, but the general lesson is meaningful: To combat inequality, it is necessary to move beyond the existing legal framework and further regulatory intervention will be required.

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