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Freedom of Contract under Heavy Regulation as Reflected in Real Estate Transactions in
Mainland China - Judicial Relaxation of Real Estate Transaction Regulation

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Abstract:

This paper investigate the freedom of contract in real estate transaction in China, enforced by Chinese courts, in spite of heavy administrative regulations imposed on real estate transaction in Mainland China. The author identifies prohibitive or restrictive provisions on who can sell and buy real property in China, on what kinds of real estate that can be traded, and on how the contract shall be negotiated and even, how contract shall be performed. Theoretically, incompliance with any of those provisions might lead to a void contract. Judges in China, however, obviously takes a different view on how real estate transaction shall be carried out in China. A careful studies of a serious of Supreme People’s Court’s judicial interpretations on real estate transaction lead to the conclusion that judges in China tends to enforce a contract even if its “violates” certain prohibitive or restrictive provisions. No speculations are given in the paper on what behind that. By simply describing the fact, however, the author tends to demonstrate that judges in China are definitely not applying the law rigidly; rather, they are trying to apply “out-of-dated laws” in a more “updated” way.

Introduction

Real estate transaction, especially real estate transfer, is first of all an issue of private contract. Due to the special nature of the subject matter of these transactions, however, real estate transactions in Mainland China are also under heavy governmental regulation. The author in this article endeavors to explain the Chinese government’s regulatory measures on real estate transfers, and to discuss the relationship between regulation and freedom of contract.

This article includes four Parts. Part I will introduce and clarify some basic concepts concerning real estate transactions in Mainland China, and discuss various governmental regulations on real estate transactions. Part II, on the foundation of the freedom of contract doctrine and the basic theory of governmental regulation, reviews the reasonableness of governmental regulation in the field of real estate and the effectiveness of the freedom of contract doctrine under such regulation. After a brief on the theory of relaxing contract invalidity, the author suggests applying this theory to real estate transactions so as to solve the possible conflict between regulation and freedom of contract. Building upon the foundation laid in Parts I and II, the author in Part III reviews some judicial interpretations of (the) Supreme People’s Court concerning real estate transactions, and points out that (the) Supreme People’s Court in practice

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has already been applying the theory of relaxing contract invalidity to solve relevant questions. The Conclusion summarizes discussions in the main body of this article.

Part I. Basic Information on Real Estate Transactions and Governmental Regulation in Mainland China

I. Concept and Characteristics of Real Estate Transactions

There is disagreement among civil law scholars as to the scope of a real estate transaction. The narrow doctrine asserts that real estate transactions are only sales, while the broad doctrine asserts that real estate transactions include real estate sales, tenancy, mortgage and other forms.¹ The *Law of the People's Republic of China on Administration of Urban Real Estate* promulgated in 1995 adopted the broad doctrine by providing that transactions of real estate within urban zoning areas “include real estate transfer, real estate mortgage and house tenancy”.² “Chapter IV Real Estate Transactions” in this Law provides for “real estate transfer (Subchapter II)”, “real estate mortgage (Subchapter III)” and “house tenancy (Subchapter IV)”. Article 2.0.15 of the *Standard of Basic Terminology for Real Estate Industry*³ issued by (the) Ministry of Construction in 2003 also adopts the broad doctrine by defining real estate transactions as land grant, real estate transfer, tenancy, pawn, and other forms of transactions in the real estate market. Given theoretical controversies over the nature of the state-owned land use right grant contract⁴, in this article the author confines real estate transactions to real estate transfer, real estate mortgage and building tenancy, and mainly focuses on transfer transactions of urban real estate.

Under the Mainland Chinese legal system, a real estate transfer means “an act whereby a real estate proprietor transfers his real estate to another person through sale, donation or other legal means.”⁵ A real estate mortgage means “an act whereby a mortgagor provides the mortgagor’s lawful real estate to the mortgagee as security for the fulfillment (performance) of a debt in the manner that the possession of the real estate is not transferred to the mortgagee. Where the debtor fails to fulfill (perform) his debt, the mortgagee shall by operation of law have the priority right to

¹ As for detailed discussion of the controversy between the narrow doctrine and the broad doctrine, see Cui Jianyuan, *Studies on Chinese Real Estate Laws*, China Legal Publishing House, March 1995 (first edition), (p.) 83.

² Article 2.3 of the *Law of the People's Republic of China on Administration of Urban Real Estate* (adopted at the eighth session of the Standing Committee of the eighth National People's Congress on July 5, 1994, promulgated on July 5, 1994, and effective as of January 1, 1995, hereafter referred to as “*Law on Administration of Urban Real Estate*”).

³ *Standard of Basic Terminology for Real Estate Industry*, issued by Announcement No.127 of the Ministry of Construction on March 17, 2003, and effective as Industrial Standard No. JGJ/T 30-2003 of the People’s Republic of China as of June 1, 2003 (hereafter “*Standard of basic terminology for real estate industry*”).

⁴ There has been theoretical controversy over whether state-owned land use right grant contracts are civil contracts. See, for example, Dong Fan, “land use right grant contracts aren’t administrative contracts”, in *China Real Estate Business*, March 5, 2007, 18. That’s one of the reasons why the author doesn’t discuss land use right grant contracts in this article.

⁵ Article 36 of the *Law on Administration of Urban Real Estate*; Article 7.0.6 of the *Standard of basic terminology for real estate industry*.

be paid with proceeds from auction of the real estate mortgaged.”⁶ A building tenancy means ”an act whereby the owner of a property as the landlord leases his property to a tenant for use and the tenant pays rent for such use to the leaser.”⁷

As for the nature of real estate transactions, the academic community has a quite consistent understanding that a real estate transaction is a civil juristic act between equal entities. Real estate transactions between the parties shall be preceded on an autonomous and voluntary basis and in accordance with the freedom of contract principle, and no organization or individual may abusively interfere in such transactions.⁸

II. Governmental Regulation on Real Estate Transactions

As mentioned above, real estate transaction is an area heavily regulated by the government. Regulations are mainly in the following aspects:

1. Restrictions on Subject Matter of Transaction

The public ownership of land in Mainland China establishes that the ownership of land may not be the object matter of transaction.⁹ At present, also, there is no express legal provision for the

⁶ Article 46 of the *Law on Administration of Urban Real Estate*. Article 7.0.7 of the *Standard of basic terminology for real estate industry* defines a real estate mortgage as “a house owner’s act whereby, for his borrowing or his guaranty for the fulfillment (performance) of a third party’s debt, the owner pledges (uses) the building as security for the creditor’s right of the obligee against the obligor in a manner that the possession of the house is not transferred”.

⁷ Article 52 of the *Law on Administration of Urban Real Estate*. Article 7.0.11 of the *Standard of basic terminology for real estate industry* defines a building tenancy as “an act whereby the owner or manager of a property provides the property owned or managed by him to a tenant for use and the tenant obtains the right to possess and use the property by paying rents at regular time for specified amounts.”

⁸ See, for example, Cui Jianyuan, *Studies on Chinese Real Estate Laws*, China Legal Publishing House, March 1995 (first edition), p83.

⁹ Article 10 of *The Constitution of The People's Republic of China* (adopted at the fifth Session of the fifth National People's Congress on December 4, 1982 and promulgated by the National People's Congress on December 4, 1982; as amended by the *Amendments to the Constitution of the People's Republic of China* adopted at the first session of the seventh National People's Congress on April 12, 1988, the *Amendments to the Constitution of the People's Republic of China* adopted at the first session of the eighth National People's Congress on March 29, 1993, the *Amendments to the Constitution of the People's Republic of China* adopted at the second session of the ninth National People's Congress on March 15, 1999, the *Amendments to the Constitution of the People's Republic of China* adopted at the second session of the eighth National People's Congress on March 14, 2004, hereafter “*the Constitution*”) provides:

Land in cities is owned by the State.

Land in rural areas and city suburban areas is owned by collectives except for those portions owned by the State as specified by laws; homesteads and privately farmed plots of cropland and hilly land are also owned by collectives.

To the extent necessary for the public interest, the State may expropriate or take over land and pay compensation in accordance with laws.

transfer of the right to homesteads on rural collective land.¹⁰ Pursuant to Article 128 of the *Property Law*, contractual operation right of rural collective land may be circulated by such means as subcontracting, swap, and transfer. However, the period of circulation may not be longer than the remaining (term) the contracting period. Without approval in accordance with law, contracted land may not be used for non-agricultural construction purposes. Except in few localities,¹¹ the right to use non-agricultural construction land on rural collective land at present may not be transferred in principle.¹²

The right to use construction land on urban state-owned land, that is, a usufructuary right on state-owned land acquired through grant or allocation,¹³ may, in principle be transferred, swapped, contributed as capital, donated or mortgaged.¹⁴ However, in case of either granted land use right or allocated land use right, the transfer must satisfy certain conditions precedent. According to the provision of Article 38 of the *Law on Administration of Urban Real Estate*, “In the case of land

No organization or individual may embezzle (converse), buy, sell or otherwise unlawfully transfer land. The land use right may be transferred in accordance with laws.

Any organization and individual using land must use the same in a rational manner.

¹⁰ Article 152 of the *Property Law* (adopted at the fifth session of the tenth National People's Congress on May 16, 2007 and scheduled to come into effect on October 1, 2007, hereafter “*Property Law*”) that has not yet come into effect provides: “the acquisition, exercise and transfer of the right to homestead are governed by laws including Land Administration Law and relevant provisions of the State.” Article 63 of the *Land Administration Law of the People's Republic of China* (adopted at the sixteenth session of the Standing Committee of the fourth National People's Congress on June 25, 1986, as amended for the first time by the *Decision on Amending the Land Administration Law of the People's Republic of China* adopted by the fifth session of the Standing Committee of the seventh National People's Congress on December 29, 1988; revised at the fourth session of the Standing Committee of the Ninth National People's Congress on August 29th, 1998; and amended for the second time by the *Decision on Amending the Land Administration Law of the People's Republic of China* adopted by the eleventh session of the Standing Committee of the tenth National People's Congress on August 28th, 2004) provides: “The right to use land collectively owned by farmers may not be assigned, transferred or leased out for non-agricultural construction; ...” Pursuant to the spirit of this provision, the right to homestead seems to be not transferable. However, Article 62.4 of the same Law provides: “Where a farmer applies for a new homestead after selling or leasing his houses, such application shall not be approved.” Pursuant to terms of this clause, the right to homestead seems to be transferable together with houses.

¹¹ For example, Guangdong Province. According to *Measures on Administration of Circulation of the Use Right of Collective Construction Land* (adopted at the 66th executive meeting of the tenth People's Government of Guangdong Province on May 17, 2005, effective as of October 1, 2005), collective construction land may be assigned, leased, transferred, subleased or mortgaged.

¹² Article 63 of the *Land Administration Law* provides: “The right to use land collectively owned by farmers may not be assigned, (conveyed), transferred or leased out for non-agricultural construction, except for legal transfer (by operation of law) of land use right caused by bankruptcy or merger and acquisition of an enterprises that satisfies the general zoning plan for land utilization and has legally obtained the construction land.” The *Property Law* has no breakthrough in this respect. Article 151 of the *Property Law* provides: “Where the collectively owned land is used as construction land, the formalities shall be governed by provisions of such laws as Land Administration Law.”

¹³ Article 137 of the *Property Law*.

¹⁴ Article 144 of the *Property Law*.

use right acquired by means of grant, transfer of the real estate shall satisfy the following conditions precedent: 1. to have paid in full the land use right grant charge as agreed in the grant contract and have obtained the certificate of land use right; and 2. to have invested for development as agreed in the grant contract, and have completed twenty-five percent or more of the total development investment in the case of a housing construction project, or have created conditions for land use for industrial or other construction purposes in the case of a tract of land development. Where the house construction has been completed at the time of transferring the real estate, the house ownership certificate shall also have been acquired. Article 39 of the same Law provides for the transfer of allocated land use right.¹⁵

In Mainland China, commercial houses under construction may be sold as pre-sold commercial houses provided that certain conditions are satisfied (met). Article 44 of the *Law on Administration of Urban Real Estate* provides for (the) conditions precedent to the presale of commercial houses.¹⁶ From 2005 onward, prior to the completion of delivery and the title registration of a commercial house, a purchaser of the pre-sold commercial house may not assign his interest in the presale contract.¹⁷

¹⁵ Article 39 of the *Law on Administration of Urban Real Estate* provides: “In the case of land use right acquired by means of allocation, the transfer of the real estate shall be submitted to the people's government that has the approval authority for examination and approval according to provisions_(regulations) of the State Council. Upon approval of such transfer by such competent people's government, the transferee shall go through the land use right grant formalities and pay (for) the land use right grant charge according to relevant provisions (regulations) of the State. In the case of land use right acquired by means of allocation, where in the course of such submission for approval of the real estate transfer, the people's government that has the approval authority decides in accordance with provisions (regulations) of the State Council that the land use right grant formalities may be dispensed of, the transferor shall turn over the land revenue to the State from proceeds resulting from the real estate transfer or dispose of such land revenue otherwise pursuant to provisions (regulations) of the State Council.

¹⁶ Article 44 of the *Law on Administration of Urban Real Estate* provides: “A presale of commercial houses shall satisfy the following conditions: 1. To have paid in full the land use right grant charge and obtained the land use right certificate; 2. to hold a permit for construction project; 3. calculated on the basis of the commercial houses provided for presale, the funds put into the development construction have reached twenty-five percent or more of the total construction investment for the project, and the construction schedule and the date of completion for delivery have been set; and 4. to have registered for (the) record the presale at the real estate administrative department of the people's government at or above the county level, and to have obtained the commercial houses presale permit.

¹⁷ Article 45 of the *Law on Administration of Urban Real Estate* provides: “In the case of presale of commercial houses, matters concerning the transfer of uncompleted pre-sold commercial houses by pre-purchasers of such houses shall be prescribed by the State Council.” On May 9, 2005, the Administrative Office of the State Council circulated the *Opinion on the Task of Stabilizing Residential Housing Prices* formulated by the Ministry of Construction, National Development and Reform Commission, Ministry of Finance, Ministry of Land Resources, People’s Bank of China, State Administration of Taxation, and China Banking Regulatory Commission on April 30. Clause 7 of this Opinion provides (states) that, in accordance with relevant provisions of the *Law of the People's Republic of China on Administration of Urban Real Estate*, the State Council decides to forbid pre-purchasers of commercial houses from transferring uncompleted pre-sold commercial houses that they purchased. Prior to the completion for delivery of the pre-sold commercial house and the acquisition of ownership certificate for the house by the pre-purchaser, the real estate administrative department may not handle formalities, including transfer

Furthermore, real estate transactions in Mainland China follow the principle of “building and land goes together, building follows land, land follows building”. The *Property Law* confirms this principle.¹⁸

2. Restrictions on Parties to Transactions

There are also restrictions as to what parties may transact in real estate.¹⁹ (1) State organs, associations, armies, or enterprises and institutions may not purchase or purchase in disguised form urban private houses, In the case of indispensable purchase due to special needs, such purchases must be approved by the people’s government at or above the county level. (2) If it is necessary to sell an urban private house purchased or built at low cost on the basis of subsidy from the State or from enterprises or institutions, the house may only be sold to the original subsidizing unit or house administrative agency. (3)... (4) In the case of sale of an house publicly held, the original residents have the priority to purchase, after a staff or worker purchased an old house for residence or and lives there for a certain period (typically 5 years), the house may be sold, provided that the original selling unit has the priority to purchase it.

Article 24 of the *Temporary Measures on Administration of Urban Residential Cooperatives* provides: “Residential houses of a cooperative may not be rented or sold to the public. Where a member’s household no longer needs the residential house, he must return the residential house in which he resided to his residential cooperative.”

Furthermore, as a part of the macro-adjustment from 2005 onward, the *Opinion on the Access and Administration of Foreign Capital in the Real Estate Market* promulgated on and effective as of November 7, 2006²⁰ imposes strict restrictions on overseas institutions’ and individuals’ real estate investment activities in Mainland China. Part I.1 of this Opinion provides: “Overseas

formalities for such pre-purchaser; where the applicant for ownership (certificate) and the pre-purchaser specified in the presale contract registered are different, the house ownership registration agency may not handle the house ownership registration formalities for him. Real name-based house purchasing system shall be established and real time online registration of commercial house presale contracts shall be carried out, so as to prevent covert private transactions.

¹⁸ Article 146 of the *Property Law* provides: “In the case of a transfer, swap, contribution as capital or donation of a construction land use right, the buildings, structures affiliated to the land and their auxiliary facilities shall be disposed of along with the transaction. Article 147 of the said Law provides: “In the case of a transfer, swap, contribution as capital or donation of a building, structure and their auxiliary facilities, the right to use the construction land occupied by such building, structure and auxiliary facilities shall be disposed of along with the transaction.”

¹⁹ Wei Xiuling (ed.), *Real Estate Laws*, China Legal Publishing House, China Zhigong Publishing House, August 2002(first edition), p194. That author illustrates these restrictions in discussing the subject matter of transaction. But the author of this article considers these restrictions are discussed more from the perspective of parties to transaction.

²⁰ *Opinion of the Ministry of Construction, Ministry of Commerce, National Development and Reform Commission, People’s Bank of China, State Administration for Industry and Commerce, State Administration of Foreign Exchange on the Access and Administration of Foreign Capital in the Real Estate Market* ((JianZhuFang No.[2006]171) issued on and effective as of October 7, 2006, hereafter “*Opinion on the Access and Administration of Foreign Capital in the Real Estate Market*”).

institutions and individuals in investing in and purchasing real estate other than for their own uses within the territory of China shall abide by the commercial presence principle, and apply to set up foreign invested enterprises in accordance with provisions concerning foreign investment in real estate; only after approval by relevant department and completing relevant registrations may they conduct relevant activities within the scope of business verified and approved. As for overseas institutions and individuals purchasing houses, the Opinion provides: “Branches or representative offices established by overseas institutions within the territory of China (other than enterprises approved to engage in the real estate industry) and overseas individuals working or studying in China for over one year may purchase actually necessary commercial houses for their own use or residence, but may not purchase commercial houses for purposes other than for their own use or residence. Overseas institutions establishing no branch or representative office within the territory of China or overseas individuals working or studying in China for less (than) one year may not purchase commercial houses. If necessary for living, residents of Hong Kong, Macau and Taiwan Region may purchase commercial houses for their own residence of certain floor size.”²¹

3. Restrictions on Contracting Behaviors and Forms of Contract

In Mainland China, all contracts concerning real estate transaction are required to be in writing. For example, Article 40 of the *Law on Administration of Urban Real Estate* provides: “In the case of a real estate transfer, a written transfer contract shall be executed in which the means of acquiring the land use right shall be specified. Article 144 of the *Property Law* reiterates this.”²² Furthermore, commercial house pre-sale contracts also shall be filed for record.²³

Besides requirements for forms of contracts, laws, regulations and departmental rules provide for restrictive or prohibitive requirements for certain specific issues in the course of concluding contracts. For example, *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*²⁴ issued by Ministry of Construction, State Development and Reform Commission and State Administration for Industry and Commerce in 2006 contains specifies prohibitions of some practices in real estate transactions. Part II of this Notice provides that (1) after obtaining the presale permit, the real estate development enterprise shall begin (to) sell

²¹ Part III.10 of the *Opinion on the Access and Administration of Foreign Capital in the Real Estate Market*.

²² This Article provides: “In the case of a transfer, swap, contribution as capital or donation of a construction land use right, the parties shall execute corresponding contracts in writing. The period of use shall be determined by the parties, but it may not be longer than the remaining period of the construction land use right.”

²³ Article 44 of the *Law on Administration of Urban Real Estate* provides that the pre-seller of commercial houses shall “...have registered for record the presale at the real estate administrative department of the people's government at or above the county level...” Based on this, various localities have formulated their own detailed implementation regulations, especially, Shanghai and Nanjing established their respective prior announcement registration system for presale of commercial houses. After the *Property Law* comes into effect, how to transform the existing contract registration for record system into the prior announcement registration system under the *Property Law* is an issue deserving studies.

²⁴ *Notice of Ministry of Construction, National Development and Reform Commission and State Administration for Industry and Commerce on Further Neatening and Standardizing the Real Estate Transaction Order* (JianZhuFang No. [2006]166), hereafter the “*Notice on Further Neatening and Standardizing the Real Estate Transaction Order*”)

commercial houses within 10 days. As for projects without commercial house presale permit, the real estate enterprise may not illegally pre-sell commercial houses, nor may the enterprise pre-sell commercial houses in disguised forms by means of subscription (including signing-up, registration, straws-drawing, etc), collection of fees of the nature of deposit, or otherwise.²⁵ (2) Real estate enterprises are prohibited from willfully hyping, bidding up house prices through releasing false information, cooking house ticket, reserving better houses for later good prices, hoarding house sources, etc, or conniving with their employees to boost house prices, so as to disturb the market order. Further transfer of pre-sold uncompleted commercial house is strictly prohibited.²⁶ (3) Commercial house presale advertisement for real estate projects without commercial house presale permit is prohibited. The circumstances of presale advertisement without presale permit, promising to undertake tenancy after sales or cost-return sales (i.e. lump sum price paid being returned in installment later), or advertisements with false or illegal contents concerning such contents as name, area, price, usage, location, surrounding environment, supporting facilities of the real estate project, shall be treated seriously.²⁷ (4) Real estate enterprises with bad track record of serious breach of laws and regulations and commercial house projects not up to presale (sale) conditions may not participate in real estate exhibitions.²⁸ (5) Real estate development enterprises shall enter into commercial house presale (sale) contracts with purchasers based on model contracts formulated by state or local construction (real estate) or industrial and commercial administrative departments. In drafting standard clauses of commercial house sales contracts, the real estate development enterprises may not exonerate themselves, aggregate liabilities of purchasers, and may not preclude legitimate rights of purchasers. Model commercial house presale (sale) contracts and standard clauses shall be expressly disclosed to purchasers prior to the execution of contracts.²⁹

4. Regulation on Performance of Contract—Illustrated by Regulation on Proceeds from House Presales and Secondhand House Sales

In order to control possible risks resulting from presales of commercial houses, Chinese laws establish a strict funds regulation system for presales of commercial houses. Article 44 of the *Law on Administration of Urban Real Estate* provides that proceeds from presales of commercial houses must be used for the construction of relevant projects. Article 11 of *Measures on Administration of Presales of Urban Commercial Houses*³⁰ requires real estate administrative departments of every locality establish a system of regulating presales of commercial houses. At present, various localities in Mainland China have created a variety of effective regulation

²⁵ Part II.2 of the *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*.

²⁶ Part II.3 of the *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*.

²⁷ Part II.4 of the *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*.

²⁸ Part II.5 of the *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*.

²⁹ Part II.6 of the *Notice on Further Neatening and Standardizing the Real Estate Transaction Order*.

³⁰ *Measures on Administration of Presales of Urban Commercial Houses* (issued by Ministry of Construction Order No. 40 on November 15, 1994, as amended by *Decision of Ministry of Construction on Amending Measures on Administration of Presales of Urban Commercial Houses* on August 15, 2001), hereafter “*Measures on Administration of Presales of Urban Commercial Houses*”.

modes.³¹

The fact that secondhand house intermediate agencies rely on and embezzle clients' funds has become a public secret. Thanks to this, Ministry of Construction and People's Bank of China issued *Notice on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Capital Accounts*³² in December 2006, requires: (1) Real estate brokerage contracts shall specify payment terms and specific payment methods of transactions funds.³³ (2) To develop transaction guarantee agencies specializing in regulation and supervision of transaction funds. If parties to a transaction agree to transfer the transaction funds through a special deposit account for clients' transaction settlement funds opened by a real estate brokerage agency or a transaction guarantee agency in a bank, they must transfer the transaction funds through the special deposit account for clients' transaction settlement funds. Ownership of transaction settlement funds in this account belongs to the parties to the transaction, independent of the proprietary property of the real estate brokerage agency or transaction guarantee agency and other property managed by them, and such funds are not liabilities of the real estate brokerage agency or transaction guarantee agency, either.³⁴ (3) The real estate brokerage agency or transaction guarantee agency shall ensure the payment terms and specific methods of funds in the special deposit account for clients' transaction settlement funds consistent with those agreed in the real estate brokerage contract.³⁵

Part II. Conflicts between Governmental Regulation and Freedom of Contract in Real Estate Transactions and their Possible Solutions

I. Possible Conflicts between Governmental Regulation and Freedom of Contract in Real Estate Transactions

According to the traditional public regulation theory, concerns over possible market failure are the most important reason for public regulation.³⁶ Market failure means ineffective allocation of resources caused by inherent defects of the market, reasons of which include

³¹ These modes include governmental regulation-based Guangzhou Mode, bank's regulation-based Nanjing Mode, construction supervisory agency's regulation-based Chongqing Mode, notary public's regulation-based Xiamen Mode, and guarantee company's regulation-based Jinan Mode.

³² *Notice of Ministry of Construction and People's Bank of China on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Funds Accounts*, (JianZhuFang No.[2006]321) issued on December 29, 2006, hereafter "*Notice on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Funds Accounts*".

³³ Part IV of the *Notice on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Funds Accounts*.

³⁴ Part V of the *Notice on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Funds Accounts*.

³⁵ Part VII of the *Notice on Issues concerning Strengthening the Administration of Real Estate Brokerage and Standardizing the Management of Transaction Settlement Funds Accounts*.

³⁶ Richard A. Posner, *Economic Analysis of Law (vol.1)*, Chinese version translated by Jiang Zhaokang and proof-read by Lin Yifu, Encyclopedia of China Publishing House, June 1997 (first edition), p367.

monopolization, externality, public good, information asymmetry, etc.³⁷ It is the very reason why the Mainland Chinese government regulates and adjusts the real estate market.³⁸

However, multiple governmental regulations over real estate transactions seem to have inherent conflict with the freedom of contract doctrine. Given the extensive governmental regulation on real estate transactions, a transaction might violate governmental regulations on subject matter parties to transaction, contracting procedure or form of contract, or contract performance requirements. If all such violations are found to invalidate a contract without exception, it will lead to the serious consequence that numerous transactions are beyond the protection of laws.

II. The Theory of Relaxing Contract Invalidity and its Possible Efficacy

German civil law theory divides ineffective juristic acts into: completely invalid juristic act, partially invalid juristic act, convertible invalid juristic act, relative invalidity of dispositive act, voidable juristic act, validity-in-pendency juristic act.³⁹ In the case of a partially invalid juristic act, the causes of the invalidity relate only to a part of the juristic act.⁴⁰ According to relevant provisions of German Civil Code, if a part of a juristic act is invalid, the juristic act is invalid in its entirety, except as it can be determined that the juristic act even without the invalid part can still stand.⁴¹ A conversion of invalid juristic act, means a circumstance where an invalid juristic act can be valid as another juristic act, provided that this juristic act satisfy the elements of the “another juristic act” and it can be deemed that should the parties have known this act is invalid they would have regarded the “another juristic act” valid.⁴² Article 42 of Dutch Civil Code provides that “if the essential contents of an invalid juristic act are so consistent with those of an alleged valid juristic act that should the former act be given up due to its invalidity the latter act will be made, the former juristic act will be given effects of the latter juristic act, except as it will be unreasonable to interested parties other than parties to the act.”⁴³ On the basis of this theory,

³⁷ See Zheng Meihua, “Analysis of Impacts of Market Failure on Chinese Economic Development”, *Sci/Tech Information Development & Economy*, 2007 Vol.17 No.2, pp114-115.

³⁸ See, for example, Yang Jianping and Zheng Qin, “Information Asymmetry and Market Failure in the Field of Real Estate”, *Market Modernization*, February 2007 (3rd issue) No.495, p230; Wu Lian, “Harm of Over-marketization from the perspective of the Lose of Control of Real Estate”, *Studies on Marxism*, 2007 No.2, pp. 232-36.

³⁹ [Germany] Karl Larenz, *General Introduction to German Civil Law (Vol. 2)*, Chinese version translated by Xie Huaishi etc., Law Press China, January 2003 (first edition), pp626-680.

⁴⁰ [Germany] Karl Larenz, *General Introduction to German Civil Law (Vol. 2)*, Chinese version translated by Xie Huaishi etc., Law Press China, January 2003 (first edition), p 632.

⁴¹ Article 139 of German Civil Code: If a part of a juristic act is invalid, the juristic act is invalid in its entirety, except as it can be determined that the juristic act even without the invalid part can still stand. Cited from <http://www.lawon.cn/law/viewDetail.jsp?id=120931>.

⁴² Article 140 of German Civil Code: If a invalid juristic act satisfies the elements of another juristic act and it can be determined that should the parties have known this act is invalid they would have conducted the another juristic act, the another juristic act is valid. Cited from <http://www.lawon.cn/law/viewDetail.jsp?id=120931>.

⁴³ Xu Ying, *The Doctrine of Conversion of Invalid Juristic Act in Dutch Civil Code*, cited from CCELAWS, Column of “Translation and Studies of Dutch Civil Code” at http://www.ccelaws.com/hlmf_show.asp?id=14.

Chinese scholars proposed the theory of relaxing contract invalidity.⁴⁴ Professor Li Renyu also put forward specific methods of relaxing contract invalidity, i.e. partial contract invalidity, rectification of invalidity, conversion of invalidity, etc.⁴⁵ The author here believes this theory may solve the above-mentioned problems.

Part III. Relevant Judicial Interpretations by the Supreme People's Court and their Role in Solving Conflicts between Freedom of Contract and Governmental Regulation in the Area of Real Estate Transactions

In fact, from some of the judicial interpretations of the Supreme People's Court, we may feel that the Supreme People's Court are consciously or unconsciously relaxing the impact on contract from governmental regulations in the area of real estate transactions. In other words, justices in Supreme People's Court possibly are applying the theory of relaxing contract invalidity to solve conflicts between governmental regulation and freedom of contract.

Among comprehensive judicial interpretations issued by the Supreme People's Court in recent years, those relating to real estate transactions are mainly the following ones: (1) *Reponses to Certain Matters in the Trial of Real Estate Development and Operational Cases Arising before the Implementation of the Law on Administration of Real Estate*⁴⁶; (2) *Interpretation of Supreme Peoples Court on Certain Matters Concerning Law Application in the Trial of Cases Arising from Commercial House Sales Contracts*⁴⁷; (3) *Interpretation of Supreme People's Court on Matters Concerning Law Application in the Trial of Cases Arising from Contracts Involving the Right to Use State-owned Land*⁴⁸. The above-mentioned judicial interpretations suggest a loose interpretation mainly for validity of contracts violating governmental regulations concerning subject matter of transaction.

1. Confirming the Validity of contracts violating governmental regulations concerning subject matter of transaction:

The most typical example in this respect is the provision of "Part III Issues concerning Transfer of State-owned Land" in the *Reponses to Certain Matters in the Trial of Real Estate Development*

⁴⁴ Li Renyu, *Studies on Effect of Contract*, Peking University Press, May 2006, p246.

⁴⁵ Li Renyu, *Studies on Effect of Contract*, Peking University Press, May 2006, p247.

⁴⁶ *Reponses to Certain Matters in the Trial of Real Estate Development and Operational Cases Arising before the Implementation of the Law on Administration of Real Estate* (deliberated and adopted at the 777 session of the Judicial Committee of Supreme People's Court), (FaFa No.[1996] 2) issued on December 27, 1995

⁴⁷ *Interpretation of Supreme Peoples Court on Certain Matters Concerning Law Application in the Trial of Cases Arising from Commercial House Sales Contracts* (Adopted at the 1267th session of the Judicial Committee of Supreme People's Court on March 24, 2003, FaShi No. [2003]7, issued on April 28, 2003, and effective as of June 1, 2003.

⁴⁸ *Interpretation of Supreme People's Court on Matters Concerning Law Application in the Trial of Cases Arising from Contracts Involving the Right to Use State-owned Land*, adopted at the 1334th session of the Judicial Committee of Supreme People's Court on November 23, 2004, FaShi No. [2005] 5, issued on June 18, 2005, and effective as of August 1, 2005.

and Operational Cases Arising before the Implementation of the Law on Administration of Real Estate: “6. In the case of a contract transferring a land use right on state-owned land if the assignment approval formalities for the land use right to be transferred have not been completed in compliance with laws, the contract generally shall be ruled invalid; however, pending the first instance litigation, in the case of the transfer of collective land use right, after the land being converted into state-owned land through expropriation formalities remediate upon relevant competent authority’s approval, and assignment formalities being fulfilled according to laws, or in the case of the transfer of state-owned land use right without due approval, the contract may be ruled valid. 7. The transferring party in a transfer contract shall be a land user who has completed formalities for land use right registration or registration for changes and obtained the land use certificate. A contract that a land user without land use certificate signs as the transferring party with another party generally shall be ruled invalid; however, where the transferring party has invested in the development and utilization of the land pursuant to the contract, and pending the first instance litigation the formalities for land use right registration or registration for changes have been remediate upon relevant competent authority’s approval, the contract may be ruled valid. 8. Where although the land user who obtained the land use right by means of grant has obtained the land use certificate, he has not invested in the development and utilization of the land pursuant to the period and terms agreed in the land use right grant contract, if the land user enters into a land use right transfer contract with another party, the contract generally shall be ruled invalid; where the land user has invested certain funds but not to the extent of meeting the period and terms agreed in the use right grant contract, if the land user enters into a land use right transfer contract with another party in absence of other unlawful actions, upon recognition of relevant competent authority by its agreeing to this transfer, the contract may be ruled valid and the court may order the parties to remediate the formalities for land use right transfer registration at relevant competent authority. 9. Where a land user with land use right hasn’t developed the land for construction in accordance with the requirement for project construction and hasn’t completed the approval formalities and formalities for land use right transfer, if the land user transfers the construction project, the contracts for the project transfer and land use right transfer generally shall be ruled invalid; if the conditions for land use right transfer are met, the contracts may be ruled valid and the court may order the parties to remediate the formalities for land use right transfer registration. 10. The use period of the land use right acquired by means of transfer shall be the remaining period of the use period agreed in the land use right grant contract deducted by the period already lapsing during the use of the original land user. Where the land user period agreed in the transfer contract is longer than the remaining period, the portion beyond the remaining period is invalid. The land use right generally shall commence from the next day after the date when the parties complete formalities for land use right registration or registration for changes and obtain the land use certificate, or the parties may stipulate the commencing time of the land use period in the contract. 11. Where the land use right transfer contract changes the land usage agreed in the land use right grant contract without authorization, the transfer contract generally shall be ruled invalid; however, if pending the first instance litigation the approval formalities are remediate, the contract may be ruled valid.”

The above-mentioned judicial interpretation applies only to real estate development and operational disputes occurring before the implementation of the *Law on Administration of Urban Real Estate*. Disputes submitted to courts as litigation before or after the implementation of the

Law on Administration of Urban Real Estate may not support the argument of the author.⁴⁹ However, certain rules in *Interpretation of Supreme Peoples Court on Matters Concerning Law Application in the Trial of Cases Arising from Contracts Involving the Right to Use State-owned Land* fully demonstrate deference of Supreme People's Court to the freedom of contract doctrine in real estate transactions. For example, Article 9 of this Interpretation provides: "Where the transferor who does not obtain a certificate of granted land use right enters into a contract with the transferee, if the transferor obtains the certificate of granted land use right or the people's government that has the approval authority agrees to the transfer before the litigation is instituted, the contract shall be ruled valid." Article 11 provides: "Where the holder of land use right enters into a contract with the transferee to transfer the allotted land use right without approval by the people's government that has the approval authority, the contract shall be ruled invalid. However, if before the litigation is instituted the people's government that has the approval authority approves and handle formalities for the grant of land use right, the contract shall be ruled valid." Article 12 provides: "Where the holder of land use right enters into a contract with the transferee to transfer the allotted land use right, and before the litigation is instituted the people's government that has the approval authority agrees to the transfer and the transferee completes formalities for the grant of land use right, the contract between the holder of land use right and the transferee may be treated as a contract of compensation nature.

Supreme People's Court's deference to contracts also is demonstrated in certain clauses of *Interpretation of Supreme People's Court on Certain Matters Concerning Law Application in the Trial of Cases Arising from Commercial House Sales Contracts*. For example, Article 2 of this Interpretation provides: "Where the seller who doesn't obtain the commercial house presale permit enters into a commercial house presale contract with the purchaser, the contract shall be ruled invalid; however, if the seller obtains the commercial house presale permit before the litigation is instituted, the contract may be ruled valid. Article 6 provides "Where a party demands to declare a contract for presale of commercial houses invalid for the theory that no formalities of registration for record have been made for the contract in compliance with laws and administrative regulations, such petition may not be allowed. Where the parties stipulate the formalities of registration for record to be a condition precedent to the commercial house presale contract to come into effect, such stipulation shall be complied with, unless one party has performed a majority of his obligation and the other party has accepted such performance."

Conclusion

⁴⁹ This can be clearly demonstrated from the first paragraph of this Judicial Interpretation: "*Law of People's Republic of China on Administration of Urban Real Estate* (hereafter "*Law on Administration of the Real Estate*") has come into effect as of January 1, 1995. Real estate development and operational cases occurring after the implementation of the *Law on Administration of Real Estate* shall be dealt with in strict accordance with provisions of the *Law on Administration of Real Estate*. If a real estate development and operational dispute occurring prior to the implementation of the *Law on Administration of Real Estate* is submitted to a people's court as litigation before or after the implementation of the *Law on Administration of Real Estate*, the people's court shall deal with the case in accordance with then existing laws and policies, on the basis of clear fact findings, and reasonably in light of factual circumstances."

It might be safe to conclude that: (1) the area of real estate transactions in Mainland China is a heavily regulated one. (2) Such regulation has some conflicting aspects with the freedom of contract doctrine; however, this conflict isn't irreconcilable. (3) Some of the judicial interpretations of Supreme People's Court consciously or unconsciously applied the theory of relaxing contract invalidity in the field of real estate transactions, quite satisfactorily solving this issue.

Mr. Su Yongqin's discussion on the integration of civil law legislation and public and private laws,⁵⁰ Judge Posner's discussion on the choice between regulation and common law⁵¹ and Coase's discussion on market and laws,⁵² all contains wonderful thoughts on the relationship between regulation and autonomy or freedom of contract. If examinations in this article can of some help for the understanding of such relationship, its author will feel very honored.

This article is by no means a comprehensive introduction to real estate transactions in Mainland China. The author only tentatively selects something he considered relevant to the theme of the paper. It is not intended to cover all kinds of real estate transactions. For example, assignment of projects, real estate tenancy or mortgage is not discussed here. In other words, much has been omitted. In addition, in writing this article, the author feels his lack of in depth knowledge of economics and jurisprudence, and fails to expound on many points.

⁵⁰ Su Yongqin, *The Integration of Civil Legislation with Public and Private Laws*, Peiking University Press, October 2005 (first edition); *State Coercion in Autonomy of Private Law*, China Legal Publishing House, July 2005 (first edition).

⁵¹ Richard A. Posner, *Economic Analysis of Law (vol.1)*, Chinese version translated by Jiang Zhaokang and proof-read by Lin Yifu, Encyclopedia of China Publishing House, June 1997 (first edition), pp367-510.

⁵² See R. H. Coase, *The Firm, the Market and the Law*, the University of Chicago Press (1988).