

# Reflection on the Right of Terminate the Contract of the Defaulting Party and Resolution of the Contract impasse

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## ABSTRACT

The emergence of the contract deadlock gave rise to the discussion about whether the defaulting party can enjoy the right to terminate. In the process of compiling The Civil Code of China, the right of terminate the contract of the defaulting party aroused great controversy, which was finally recognized by the legislators and stipulated in the second paragraph of Article 580 of the Civil Code. From the perspective of existing rule interpretation, the right of the defaulting party to terminate the contract does not exist in the original normative system. Through the definition of the contract deadlock concept and the analysis of various specific cases in judicial practice, it is not difficult to find that the creation of the right of the defaulting party to terminate the contract is not necessary, the interpretation of the existing law has been able to resolve the contract deadlock, the addition of the right of the defaulting party to terminate the contract will bring system contradictions.

**Keywords:** *The Contract deadlock, The Right of Terminate the Contract of the Defaulting Party, Article 580 of the Civil Code*

## 1. INTRODUCTION

When we talk about the "defaulting party", it generally refers to the subject and content of the liability for defaulting party. By contrast, the concept of "the right of the defaulting party to terminate the contract" seems odd. Generally speaking, for the purpose of eliminating the creditor's treatment of the payment obligation, the party enjoying the legal right of rescission can only be the counterpart of the defaulting party, that is, the non-defaulting party.[1] However, in the case of "contract deadlock", whether this rule can be broken by exception has aroused extensive discussion in academic and practical circles. Based on the right of the defaulting party to terminate the contract under the contract deadlock, this paper analyzes its causes and evaluates whether it is legitimate.

## 2. ORIGIN OF THE PARTY IN DEFAULTING'S RIGHT TO RESCIND

### 2.1. Reflections on a case of *communiqué*

The right of the defaulting party to terminate the contract was first mentioned in the 2006 Supreme People's Court bulletin case "Dispute case of Xinyu Company v. Feng Yumei store sales Contract" [2](hereinafter referred to as "Xinyu Case"). In the judgment of this case, the court finally cited the judgment of "excessive performance cost" in Item 2, Article 110 of the Contract Law to allow the

defaulting party to terminate the contract, thus recognizing that the breaching party has the right to terminate the contract under special circumstances.

In the Xinyu case, the plaintiff Xinyu Company leased its floor space to two companies, but both of them were shut down due to poor management. Therefore, Xinyu company bought back its shops and rearranged the layout. Most of the owners agreed to terminate the contract and get some compensation, but the defendant Feng Yumei and another owner did not agree to terminate the contract, resulting in a dispute. The plaintiff Xinyu Company filed a lawsuit, thinking that the above situation constituted the variation of circumstances, and requested the court to order the cancellation of the shop sales contract signed with the defendant. The plaintiff was willing to give reasonable economic compensation in addition to refund the purchase price to the defendant. The court of first instance decided to terminate the contract in accordance with the principle of fairness and good faith from the perspective of balancing the damage of both parties' interests and the long-term interests in the future. After the defendant yu-mei feng appealed to the court, the second instance court based on the "contract law" article 110, paragraphs 2 think, if let Xinyu company to continue to perform the contract, its cost of performance is excessive, and it cannot meet the yumei feng's demand, so that the appeal reason is not set up and maintain the first-instance judgment for most of the content (including cancellation of the contract).

The rule established in this case is that, based on the realization of the purpose of the contract and the consideration of public interests and other factors, the defaulting party have the right to terminate the contract with exception. After the Xinyu case, many courts take it

as a reference to grant the right of termination to the defaulting party. As in the "Application for retrial of Contract Dispute between Xianqixin and Feng Xiaolin and Tang Xiaohui"[3], sichuan higher court think if continue to perform the contract, it will ruin both parties interests, in fact cannot meet the requirements, the purpose of the contract from balance interests between parties and damaged condition and the future long-term interests, according to the principle of fairness, honesty and credit, shall cancel the contract.

## **2.2. "The right of the defaulting party to terminate the contract" in legislation**

In the process of compiling the Civil Code, the right of the defaulting party to terminate the contract is the most controversial issue. Rules first appeared in the civil code of the parts (draft) under paragraph 3 of article 353, the provisions of "contract fails to fulfill the purpose of contract, people who have termination right don't terminate the contract and it is obviously unfair to the other party, the other party could request people's court or an arbitration institution to cancel the contract, but does not affect its liable for breach of contract", from the system point of view, it belongs to the statutory rescission rules. The third paragraph of Article 353 of the Contract Part of the Civil Code (the second draft) only slightly modified the expression of the rule, but the normative substance and system position did not change. One month before the release of the Civil Code (draft), the Supreme People's Court also released the Minutes of the National Courts' Civil Commercial Trial Work Conference (hereinafter referred to as the "Conference Minutes"). Article 48 of the Conference Minutes clearly stipulates the rule of "termination of litigation by the defaulting party". However, this rule was deleted in the Civil Code (draft), and the Constitution and Law Committee of the NPC interpreted it as, "The stipulation that the defaulting party can apply for termination of the contract is inconsistent with the requirements of strictly observing the contract, so it is suggested to be deleted. For individual contract deadlocks, consideration may be given to resolving the issue by applying the rule of Change of circumstances or by other means.[4] However, in the draft submitted to the NPC deputies for deliberation on May 22, 2020, the rule of the defaulting party's right to rescind appears again. However, the difference is that the position of this rule has changed from the original legal right of rescission to the actual performance exception rule of non-monetary debt. In the end, the rules of the draft version were confirmed by the legislators, forming the now adopted section 580 section 2 of the Civil Code.

## **3. WHETHER THE CURRENT LAW GIVES THE DEFAULTING PARTY THE RIGHT TO TERMINATE THE CONTRACT**

Before analyzing whether it is necessary to create the right to terminate the defaulting party, it is worth thinking whether the rule already exists in the current law. If it can be explained from the existing norms that the defaulting party has such right, then there is no need to stipulate the rules of rescission of the defaulting party separately.

### **3.1. Article 94 of the Contract Law**

Article 94 of the contract law includes two types of causes of legal rescission :(1) the purpose of the contract cannot be realized due to force majeure (item 1); (2) Default (Items 2-4). First of all, in the case of failure to achieve the purpose of the contract due to force majeure, it is generally believed that the "parties" in the item include the both parties to the contract. But this does not mean that the defaulting party have the right to terminate the contract. As a statutory exemption of liability for breach of contract, failure to perform its obligations due to force majeure does not constitute a breach of contract in the event of force majeure. Therefore, in the event that the purpose of the contract cannot be realized due to force majeure, the legal rescission right of both parties to the contract is not the rescission right in the event of breach, and there is no problem pointing to the breaching party or the non-breaching party.[5]

Second, the situation that legal rescission due to the default, in article 94, paragraphs 2 to 4, while not directly regulations shall enjoy the right of termination of the parties is to point to the default party, but looked from the legislative purpose, lawmakers are not based on the hope that give observant party and the defaulting party in breach termination right to make "the parties" as the main body, because one of the basic principles of "contract law" is "sanctity of contract", parties should perform the obligations as agreed, shall not be arbitrarily terminate the contract. The non-breaching party still needs to rely on strict provisions on the right to terminate the contract, not to mention the breaching party cannot claim to terminate the contract under the circumstances that it has deviated from the basic principles. Some people think that the "party" in article 94 of the Contract Law should be understood as the "person with right to rescind", which is not exactly corresponding to the "non-breaching party" but excluding the "breaching party". In the case of breach by both parties, the breaching party may also exercise the right of rescission according to this article. [6]This is clearly wrong.

This point of view can also be verified from the system explanation. As for the liability for breach of contract, The Contract Law of China gives creditors the option to claim in any way they think appropriate. If affirming creditor's right of choice, affirming contract law 94 contain that the

right of the breaching party to cancel at the same time, it will cause the contradiction on the standard application. As a result of the exercise of the right to rescind by the defaulting party, the creditor's right to continue to perform is actually denied, and the option of the latter is doomed to fail.[7]Therefore, from the perspective of system interpretation, article 94 of the Contract Law does not contain "the right of the breaching party to rescind".

### **3.2. Article 110 of the Contract Law**

Article 110 of the Contract Law is about the actual performance of non-monetary debt and its exception rules. When the debtor meeting the three exclusion causes listed in this article, they can claim defense (item 1) or defense right (item 2 and 3) against the creditor. Therefore, the proviso of this article is only a means against actual performance, and it does not draw a conclusion that the breaching party can terminate the contract based on the three clauses. From the perspective of the contract Law system, Article 110 is placed in the chapter of "liability for breach of contract", while the related provisions of termination belong to the chapter of "termination of rights and obligations of contract". This also indicates that rescission is a manifestation of termination of contractual rights and obligations, and article 110, as an exceptional case requesting compulsory performance, actually belongs to the category of liability for breach of contract. Therefore, the scope of inclusion in article 110 does not cover the question of termination of the contract.[8]

## **4. THE CONTRACT DEADLOCK SOLUTION PATH**

### **4.1. Problems existing in the application of Article 580 of the Civil Code**

Since it cannot be explained from the current law that the breaching party has the right to terminate, in order to apply the right to terminate the breaching party to solve the contract deadlock, we must create another rule. The second paragraph of Article 580 of the Civil Code gives the breaching party the right to terminate on the basis of article 110 of the original Contract Law. But whether this rule can solve the contract deadlock is still debatable.

According to the three specific exclusions in the first paragraph, the right of the breaching party to terminate the contract stipulated in the second paragraph of Article 580 is not appropriate. The term "inability to perform legally" in paragraph 1 refers to the inability to perform based on legal provisions, or to perform in violation of compulsory provisions of the law. [9]For example, in "one thing to sell twice" case, the seller has not been paid after sign the sale and purchase contract with the buyer and the transfer registration, then the same houses sold to others, at this

point it cannot legally to perform its obligations for the first buyer, then nature shall be liable for damages, but did not appear any deadlock, so do not need to give the breaching party termination right. When in fact it is impossible to perform, it is impossible to perform according to the laws of nature. For example, the subject matter of the sales contract is damaged or lost, since delivery of the subject matter is impossible, there is no need to continue the performance of the contract if substitutional payment cannot be made. However, there is no contract deadlock in the above two kinds of performance failure, so it is not necessary to give the breaching party the right to terminate the contract. If there is no claim for performance after the termination of the obligation of payment, it can only be converted into compensation for damages in lieu of payment or terminated without any deadlock.

Second, "the mark of the debt is not suitable for specific performance", "performance of the high cost", according to the commission of legal experts to explain, respectively, on the basis of the nature of the debt is not suitable for specific performance, or perform cost and performance but it may still cause of burden, have too much unreasonable burden or high costs. [10]For example, contracts based on a high degree of personal dependence, such as commission contracts, partnership contracts, etc. Or the compulsory performance of many contracts for the provision of services, services or omissions would jeopardize the personal freedom and personal dignity of the debtor. In this case, if the non-breaching party claims that the breaching party should continue to perform according to the service contract, the breaching party can completely form a defense based on this clause, and the contractual obligation will not need to be performed from then on. For the non-breaching party, it is meaningless not to rescind the contract, even if the non-breaching party still stubbornly refuses to rescind the contract, the breaching party will not suffer more losses, so there is no need to create the right of rescission for the breaching party.

It is same for "failure to require performance within a reasonable time" in paragraph 3. If the non-breaching party does not claim continued performance against the breaching party within a reasonable period of time, it means that it allows this to happen by default. When the non-breaching party raises a request for further performance, the breaching party may have the right of defense according to the provisions and claim to refuse performance. So far, there is no contract deadlock, then there is no need to increase the right of the breaching party to terminate the system.

### **4.2. Solutions based on existing methods**

According to the above analysis, the three provisions in article 580 (1) of the Civil Code will not cause contract deadlock, and the right of the breaching party to terminate the contract should not be established on this basis. As for other types of contract deadlock, it can be resolved

through the interpretation of existing rules, which can be discussed in the following two situations:

In the first case, the breaching party no longer has any interest in the performance of the contract based on the change of important causes. If the breaching party continues to perform the contract, it will cause heavy burden. Compared with article 580 (2) of civil Code, which limits contract deadlock to non-monetary debt, this kind of contract deadlock is often reflected as an obstacle to the performance of monetary debt. For example, Party A and Party B agree that Party A will provide house to Party B, and Party B will pay rent to Party A on a monthly basis for one year. However, after three months, Party B has to move out due to his job transfer. He hopes That Party A will take the initiative to terminate the contract and promise to pay him penalty due to breach of contract. However, Party A refuses to exercise its right to terminate the contract, resulting in an impasse of the contract. In the lessee due to its own plans to change hope to cancel the contract, shall be for the sake of their contract bound too much freedom, for the lessor to building this can further rent, demanding high penalty due to breach of contract to terminate the contract, but he delayed in action, not only cause the waste of resources, the resulting disputes will also use of public resources.

In this regard, some scholars put forward that the principle of change of circumstances can be applied, but this view obviously misunderstood the scope of application of the principle of change of circumstances. The embodiment of the principle of changed circumstances in China's law is the Interpretation II of the Supreme People's Court of Several Issues concerning the Application of the Contract Law of the People's Republic of China article 26, the terms and conditions of the statement is "Where any major change which is unforeseeable, is not a business risk and is not caused by a force majeure occurs after the formation of a contract, if the continuous performance of the contract is obviously unfair to the other party or cannot realize the purposes of the contract and a party files a request for the modification or rescission of the contract with the people's court, the people's court shall decide whether to modify or rescind the contract under the principle of fairness and in light of the actualities of the case". Change of circumstances is usually applied to the change of objective circumstances that cannot be attributed to both parties. Neither party is subjectively imputable, and contract deadlock is exactly caused by the fault of one party.[11]

By contrast, the correct approach should be to balance the interests of both parties through derogation rules. For example, in the "Dispute case of house lease contract between Hu and Christine Company",[12]the lessee Christine Company sent a letter to terminate the contract on the grounds of operating loss, and voluntarily gave up the house and exchanged keys. The lessee Hu could actively hire another house at this time, but he did not take any measures to prevent the loss from expanding. Therefore, the court held that "Hu did not provide sufficient evidence to prove that he actively sought rent to reduce the loss, etc., and the loss of Hu should be

considered as 5 months 'rent loss". The contract deadlock in this case was resolved by means of the impairment rule.

In the second case, neither the non-breaching party nor the breaching party has the right to terminate the contract. By enumerating the attitudes of both parties to the contract, some scholars draw the conclusion that "the contract deadlock will only occur if the party with the right to terminate does not exercise the right to terminate the contract and the breaching party is not willing to continue to perform the contract".[13]But in some contract deadlocks, neither party has the right to terminate the contract. For example, Party A and Party B sign a sales contract for machinery and equipment, stipulating that Party A is responsible for transporting goods from other places to the place where Party B is located, and Party B pays the price of RMB 1 million. Party A delivers the equipment to Party B in full amount according to the agreement, but Party B has a serious fund problem after paying Party A RMB 980,000, which results in party B's inability to pay the remaining RMB 20,000. Moreover, Since Party B has performed its main obligations, Party A cannot determine the right to terminate the contract. Party B has no right to terminate the contract due to breach of contract, thus forming a contract deadlock. At this point, if the party in breach should be given the right to rescind, the previous payment should also be returned to each other, resulting in the failure to achieve the purpose of the contract. In this case, this is not necessary to resolve the contract impasse, terminating the contract is not an effective way. If the fund is short for a long time, Party B can replace the actual performance by paying damages. After that, Party A has the right to request the return of the machine, and Party B can request the return of the money already paid. It is not necessary to fully fulfill the contract at this time, just as the house involved in the lease contract dispute can be sublet separately. Nowadays market development degree is relatively sufficient, buyers and sellers are actually in the two-way choice rather than a unique choice, can easily obtain similar or the same subject matter in the market.[14]

## 5. CONCLUSION

It is difficult to find traces of the right of the defaulting party to terminate the contract in the current law, and it is also impossible to find the appropriate use space and system position in the Civil Code. Therefore, it is unnecessary to give the defaulting party the right of contract termination. As for the contract deadlock, if the breaching party wants to terminate the contract due to reasons beyond its control, it can use the existing impairment rules to deal with it. Its essence is to use damages to replace actual performance. This provision violates the basic principles of good faith and strict observance of contracts in contract law, damages the basic system of contract system, and brings a lot of troubles to judicial practice. Therefore, it should be removed from the Civil Code.

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