

Judicial Efficiency, Incomplete Contract and Self-Fulfillment

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Abstract

From the perspective of the economics of law, the ruling on the first guiding case of China i.e. jump-dealing case has great breakthrough significance. It gets rid of the constraint of the hypothesis of traditional contract law on complete contracts, encourages the self-fulfillment of incomplete contract from the logic starting point of incomplete contract, highlights the incentive function of the remedy for breach of contract and emphasizes that the function of contract law is aimed to improve transaction efficiency and optimize resource allocation.

Key words: Jump-dealing; Guiding Case; Incomplete Contract; Self-fulfillment

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INTRODUCTION

On December 20, 2011, the Supreme People's Court published the first batch of four guiding cases and announced that judges should refer to these guiding cases when trying similar cases. Such stipulation means that these guiding cases have already had substantial legal binding force and broken through the traditional thought that civil law judges should not make law. Especially the first guiding case named "**Shanghai Zhongyuan Property Consultancy Co., Ltd. v. Tao Dehua Intermediary Contract Jump-dealing Case**" (hereinafter referred to as

"**Jump-dealing case**") is particularly striking.

According to facts, in the second half of 2008, in order to sell the property at issue, the original property owner, Li, listed it at multiple real estate agencies. Tao Dehua and his wife inspected the property many times under the introduction of different real estate agencies. On November 27, 2008, an agent from **Shanghai Zhongyuan Property Consultancy Co., Ltd.** (hereinafter referred to as "**Zhongyuan Company**") brought Tao Dehua to the property, and both parties signed a **Confirmation of Prospective Real Estate Purchase** (hereinafter referred to as "**Confirmation**") on the same day. According to the provision of Article 2.4 of the **Confirmation**, where, within six months after Tao Dehua inspected the property, Tao Dehua, his principal, agent, representative, or designee, or any other person associated with him concluded a deal regarding the property with any third party by using any information, opportunity or other condition provided by **Zhongyuan Company**, bypassing **Zhongyuan Company**, Tao Dehua should pay **Zhongyuan Company** liquidated damages of 1% of the actual purchase price for the property as agreed with the seller. **Zhongyuan Company's** quoted price for the property was RMB 1.65 million and its agency fee was 1% of actual purchase price. However, the quoted price of other real estate consultancy company was only RMB 1.45 million. On November 30, through brokerage of other real estate consultancy company, Tao Dehua and the seller concluded a real estate purchase contract at a purchase price of RMB 1.38 million. **Zhongyuan Company** filed suit against Tao Dehua in Hongkou District People's Court of Shanghai, and alleged that, Tao Dehua, by using information provided by **Zhongyuan Company** regarding the property, deliberately bypassed the real estate agency and directly concluded a real estate purchase contract in private with the seller, and Tao's act is a malicious jump-dealing act in violation of the provisions of the **Confirmation**. Hence, **Zhongyuan Company** requested

the court to order Tao Dehua to pay liquidated damages of RMB 16,500. The Court made the first instance ruling as follows: the defendant Tao Dehua should, within 10 days from the effective date of the ruling, pay liquidated damages of RMB 13,800 to **Zhongyuan Company**. After the ruling, Tao Dehua filed an appeal. On September 4, 2009, the No. 2 Intermediate People's Court of Shanghai issued a civil judgment (No. 1508 [2009], Final, Civil Division II, No. 2 Intermediate, Shanghai) as follows: (1) the civil judgment (No. 912 [2009], First, Civil Division III, Hongkou) was overruled; and (2) the claim of **Zhongyuan Company** that Tao Dehua should pay liquidated damages of RMB 16,500 was not granted.

The ruling on the first guiding case of China i.e. **Jump-dealing case** maintains the credibility in the dealing of real estate agency market, promotes the fair competition of market and protects the legal rights and interests of property buyers. From the perspective of the economics of law, the case has milestone significance, as it gets rid of the hypothesis of complete contract under traditional contract law, encourages the self-fulfillment of incomplete contract from the logic starting point of incomplete contract, highlights the incentive function of the remedy for breach of contract and emphasizes that the function of contract law is aimed to make resources flow to in the most valuable direction through voluntary exchange.

1. EFFICIENCY: THE FINAL PURSUIT OF CONTRACT LAW

According to traditional jurisprudence, law is imitating justice, and if the law is against justice, it can be a kind of conflict or satire, so justice should be the highest value appeal of a judicial decision. However, in the economics of law, contractual relationship contains complete economic logic and contract law's economic function is to execute the agreement that can promote efficiency, so the court should make efforts to find out the efficiency clause that can be used to optimize the total benefits of contract parties. As Richard Posner said, considering that judges only have limited remedy power and the society values diversity, efficiency may be the sole social value that judges can promote efficiently. The "efficiency" highlights that social welfare is maximized based on the maximization of personal interests, that is to say, it achieves Pareto optimality through judicial action. However, efficiency, wealth maximization and welfare maximization maybe have to conflict with fairness, equality and justice. With respect to the jump-dealing case, since Tao Dehua signed the confirmation with **Zhongyuan Company** voluntarily, it indicates that Tao Dehua has known and would like to undertake the obligation of not jump-dealing. According to the principle of honesty and credibility, under traditional contract law, Tao Dehua should have performed the confirmation

seriously as any noncompliance is illegal and should be blamed. However, efficiency principle requires that the total compensation between both parties involved in dealing shall be maximized, so the property buyer may select breach of contract if the compliance of the Confirmation would make the total compensation between both parties involved in dealing reduce, and such breach belongs to a kind of efficient choice and worth being protected by law.

Because Tao Dehua made the promise of not jump-dealing before implementation, the time difference between both would make the cost of implementation uncertain. For example, Tao Dehua didn't know whether other agencies would offer more favorable prices. If other agencies offer more favorable prices, Tao Dehua's cost of implementation would increase. Because scarce resources need to be used for implementation, so the cost of implementation will exceed benefits. In contrary, if **Zhongyuan Company's** quoted price is the sole and the most favorable one, Tao Dehua's cost of implementation may be reduced. In case that **Zhongyuan Company's** quoted price is the sole and most favorable one, Tao Dehua's cost of implementation of **Confirmation** is RMB 16,500, Tao Dehua would obtain the consumer surplus of RMB 333,500 through cooperation with **Zhongyuan Company** and **Zhongyuan Company** would obtain the agency fee of RMB 16,500; if Tao Dehua still selects to implement the **Confirmation** and cooperate with **Zhongyuan Company** after knowing that he could make dealing at RMB 1.38 million with other agency, Tao Dehua's cost of implementation would be RMB 272,700, his consumer surplus would be RMB 77,300 and **Zhongyuan Company** would obtain the agency fee of RMB 16,500; if Tao Dehua selects to violate the **Confirmation** and makes jump-dealing at RMB 1.38 million, he would face the liquidated damages of RMB 13,800 but he would save the property payment of RMB 270,000 and the agency fee of RMB 2,700, his consumer surplus would be RMB 592,400, and **Zhongyuan Company** may obtain the liquidated damages of RMB 13,800. Therefore, Tao Dehua's jump-dealing choice without cooperation with **Zhongyuan Company** will maximize total benefits, which meet efficiency principle. When judges make judicial decision, they shall maintain such optimal choice, that is to say, judges shouldn't prohibit the freedom of property buyers to make jump-dealing after trade-off.

From the above, we can find that sometimes there are some conflicts between justice and efficiency, but in fact it seems that such conflicts can be resolved. If justice and efficiency both have values and one has no absolute priority to the other, they should reach a compromise when having conflicts and judges have the responsibility to make a judgment and balance between efficiency and equality. Justice is a kind of subjective value while

efficiency is a kind of objective value. If a value judgment is made at the possibly minimum level, efficiency principle requires that lawyer's behavior should avoid waste of resources. Therefore, law interpretation should not be based on justice but by efficiency. In the economics of law, contract law has the aim to maximize efficiency or welfare but has to meet the Pareto principle.

2. INCOMPLETENESS: HYPOTHESIS OF CONTRACT LAW

According to traditional contract theory, all the agreements made on the actual intention of both parties are complete. In accordance with the terms and conditions of the Article 55 of the *General Principles of the Civil Law* on the requirements of validity of civil legal act and the terms and conditions of the Article 7 and 9 of *Contract Law*, the requirements of validity of contract include that contract parties shall have the corresponding disposing capacity of signing contract, contract parties' intentions shall be actual and contract shall not violate law or social public interests. The **Confirmation** in the **Jump-dealing Case** meets the requirements of validity of contract, so the contract is complete in the economics of law. When the contract parties have disputes on contract terms, court may force the parties to implement the contract. However, from the perspective of the economics of law, the contract is incomplete. Incomplete contract is made because of limited personal rationality, complicated and uncertain external environment and asymmetric and incomplete information. The **Confirmation** was signed when Tao Dehua did not know all the information about the property, so the **Confirmation** is incomplete and it will make optimal dealing unachieved, one contract party has the risk of being "ripped off" by the other party, personal cost and benefits are externalized and contract efficiency can't be achieved.

The law and economics have different standards to identify whether a contract is complete or not, and as a result, the **Confirmation** is complete in law but it is incomplete in economics. Based on the different standards on the incompleteness of contract in law and economics, incomplete contracts can be divided into legal incomplete contracts and economic incomplete contracts, so the former refers to the contracts without meeting the requirements of legal effect and the latter refers to the contracts meeting the requirements of legal effect but in lack of efficiency because of limited personal rationality, incomplete information and other unpredictable factors at the time of signing. Traditional contract law has detailed stipulations on the identification standards, legal responsibilities and remedy means for incomplete contracts, but it rarely stipulates economic incomplete contracts. Our contract law only has provisions about the economic incomplete conditions like force majeure and

change of circumstances etc. Force majeure and change of circumstances may happen after signing contract, which can't be forecast, avoided or remedied before signing contract, and their occurrence will change the basis of implementation of contract fundamentally. If such contract is forced to be implemented, it will damage the economics aspect of dealing. Therefore, the legal effects of force majeure and change of circumstances shall be determined.

However, our existing written legal documents have no stipulations on the economic incomplete contracts caused by limited rationality and asymmetric, incomplete and uncertain information etc., mainly because the factors of economic incompleteness are very complicated, including the objective ones like force majeure and subjective ones like limited rationality and asymmetric, incomplete and uncertain information, the connotation and extension of which can't be described accurately in legal language, and besides, it is very difficult to put to the proof on incomplete contracts. Because there is no legal provision on economic incomplete contracts, it has made some disorder in judicial decision. For example, the first-instance court may identify economic incomplete contracts based on the standards of legal incompleteness. However, luckily, the intermediate court made the judicial decision that Tao Dehua didn't undertake the obligations due to jump-dealing, which completely proves that the **Confirmation's** incompleteness was identified by law in the case, breaks through the hypothesis of traditional contract law on incompleteness and has great guiding significance.

3. SELF-FULFILLMENT: THE WAYS OF FULFILLING INCOMPLETE CONTRACTS

In reality, because of the factors like complicated, risky and uncertain social interactions, human's limited rationality, the existence of transaction fee, incomplete and asymmetric information and obscure language usage, there is almost no economic incomplete contract since it is impossible to predict all the conditions involved in a contract before determining each party's rights and obligations. Generally, the fulfillment of legal incomplete contracts will be assisted by a third-party executor, while the fulfillment of economic incomplete contracts can't get the most economic result by court enforcement. Economic incomplete contracts shall highlight more self-fulfillment but not court enforcement. The self-fulfillment of contract means personal punishment clause but not court enforcement is made for the dealing party that can be predicted to have the possibility to violate contract, that is to say, a contract shall be fulfilled by dealing parties voluntarily but not under the rule of law. Personal punishment clauses contains two aspects: firstly, the loss from specific capital investment due to termination of dealing relationship; secondly, the loss of devaluation of credibility.

According to the case, if Tao Dehua's valuation on the property was RMB 2 million, at the time, **Zhongyuan Company's** quoted price was RMB 1.65 million, Tao Dehua found that other real estate consultancy company's

quoted price was only RMB 1.45 million, and at last the property owner Li would like to sell the property at RMB 1.38 million after coordination as Li's valuation on the property was only RMB 1.2 million.

Table I
Surplus Distribution Under Remedies for Breach of Contract (Unit: RMB 10,000)

	Property valuation	Surplus distribution without remedy for breach of contract	Surplus distribution under enforcement as the remedy for breach of contract	Surplus distribution under compensation for damages as the remedy for breach of contract
Tao Dehua	200	60.62	33.35	59.24
Zhongyuan Company	165	0	1.65	1.38
A property	145	1.38	0	1.38
Li	120	18	45	18
Total		80	80	80

According to Table 1, if Tao Dehua would not like to buy the property at RMB 1.65 million through **Zhongyuan Company** but selects to violate contract because of other real estate consultancy company, **Zhongyuan Company** files suit against Tao Dehua, the court does not grant any remedy to **Zhongyuan Company**, that is to say, Tao Dehua may make jump-dealing without any cost, let's think about the benefits of the four parties. Tao Dehua may obtain the difference between his valuation and actual purchase price, i.e. RMB 620,000, but he has to pay the agency fee of RMB 13,800, so his net benefits are RMB 606,200. **Zhongyuan Company's** benefits are zero. The benefits of some real estate consultancy company are the agency fee of RMB 13,800. Li's benefits are the difference between his valuation and actual purchase price, i.e. RMB 180,000. See Table I - "Surplus Distribution Under Remedies for Breach of Contract".

If the court accepts the suit of **Zhongyuan Company** and orders Tao Dehua to fulfill contract, that is to say, Tao Dehua has to purchase the property at RMB 1.65 million, Tao Dehua may obtain the difference between his valuation and actual purchase price, i.e. RMB 350,000, but he has to pay the agency fee of RMB 16,500, so his net benefits are RMB 333,500. **Zhongyuan Company** may obtain the agency fee of RMB 16,500 and the benefits of some real estate consultancy company are zero. Li's benefits are the difference between his valuation and actual purchase price, i.e. RMB 450,000. See Table I - "Surplus Distribution Under Remedies for Breach of Contract".

If the court accepts the suit of **Zhongyuan Company** and orders Tao Dehua to follow the **Confirmation**, that is to say, Tao Dehua must pay the liquidated damages of RMB 1.65 million to **Zhongyuan Company**, Tao Dehua may obtain the difference between his valuation and

actual purchase price, i.e. RMB 620,000, but he has to pay the agency fee of RMB 13,800 and the liquidated damages of RMB 13,800, so his net benefits are RMB 592,400. **Zhongyuan Company** may obtain the liquidated damages of RMB 13,800 and the benefits of some real estate consultancy company are RMB 13,800. Li's benefits are the difference between his valuation and actual purchase price, i.e. RMB 180,000. See Table I - "Surplus Distribution Under Remedies for Breach of Contract".

Now, when we make comparisons under the three conditions i.e. without remedy, under enforcement and compensation for damages, we can find that different remedies have the same total benefits, while different remedies will affect the distribution of surplus value. For the signing parties of the **Confirmation**, the surplus distribution is more in favor of the promisee in case of having no legal remedy, while it will be more in favor of the promisor in case of having legal remedy. From the point of view of protecting consumer's interests, surplus distribution shall be more in favor of the promisee, so it is fair without remedy. From the point of view of resource allocation, the surplus distribution shall be more in favor of the party with higher valuation in case of having no legal remedy while it will be more in favor of the party with lower valuation in case of having legal remedy. From the point of view of optimal resource allocation, it is efficient without remedy. From the benefits of both real estate consultancy companies, the surplus distribution will be more in favor of the party with lower valuation in case of having no legal remedy while it will be more in favor of the party with higher valuation in case of having legal remedy. From the point of view of competition promotion, it is economic without remedy.

Based on above analysis, we can find it may be a better choice for dealing parties to find their ways of self-

fulfillment without legal remedy, which will be helpful for resource allocation towards the party with higher valuation, promotes utilization efficiency, and encourages agencies to improve their service level and tries their best to find the best property source information but not “kidnaps” consumers by confirmation and other agreements.

CONCLUSION

From the above, we can find the **Jump-dealing case** as the first guiding case of China has breakthrough significance in legal principle, premise of application and remedy means, and highlights the important function of efficiency value in judicial decision. Besides that, the **Jump-dealing Case** as a guiding case also has milestone value as it has broken the tradition that only written laws could be taken as the basis of judgment in civil law countries and promoted the integration between civil law system and common law system. Can any case be taken as guiding case? The answer is not. Taking the contract law as example, the existing standard documents have detailed stipulations on the identification standards and remedy means for legal incomplete contracts, so those written legal standards shall be referred to when judgment is made on legal incomplete contracts. However, for economic incomplete contracts, because of the difficulty in legal description and complicated uncertain factors, it is more appropriate to refer to guiding case in judgment.

The Article 7 of the *Provisions of the Supreme People's Court on Case Guidance* stipulates that: local people's courts at various levels shall refer to the guiding cases published by the Supreme People's Court". Those guiding cases come from the effective cases of the people's courts at various levels, judges' ruling may guide future judicial practice to some extent and judges have certain of legislation function. For a truly novel case, it may establish a precedent to guide future cases, so judges shall follow the precedent when trying with future similar cases and they don't have to decide each case

from the beginning, which is a kind of economic choice. In the **Jump-dealing case**, its efficiency value will have great significance for future jump-dealing cases and even contract cases. As Posner said, maybe no mark about economic thinking can be found in future cases, but if the precedent affecting future cases is established based on the desire for efficiency promotion in a implicit or definite way, reflecting the legislation action of judges, those cases can be said to be decided based on efficiency. Therefore, even if a fraction of a case concerns efficiency, law may be said to be efficient.

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