

# Construction Project Price Priority Compensation Right: Application Dilemmas, Interest Conflicts and Improvement Paths

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**Abstract:** Article 807 of the Civil Code and related judicial interpretations grant the contractor the legal priority right, namely, the priority compensation right for project prices. This right is regarded as one of the legal guarantee mechanisms in civil and commercial law, and it is endowed with functions such as safeguarding the creditor's rights of project prices, maintaining the order of the construction industry, and protecting the rights and interests of workers. However, in judicial practice, phenomena such as subcontracting, illegal subcontracting, subcontracting under false pretenses, and pre-sale housing financing keep emerging. The priority compensation right faces multiple dilemmas, including inconsistent determination of the subject scope, ambiguous requirements for the exercise procedure, and blurred positioning of the right nature. Based on this, this paper, based on existing representative research results, systematically examines the manifestations of these dilemmas and conflicts, analyzes the interest games among multiple subjects, and accordingly proposes an optimized institutional path that is in line with the actual situation of the construction market, with the aim of bridging the gap between norms and practice and promoting the standardized operation of the priority compensation right system.

**Keywords:** Civil code; Priority compensation right for project prices; Judicial interpretation; Interest balance

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## 1. Introduction

The problem of delayed payment of project prices in the construction industry has long constrained the development of the industry. Usually, the contractor, who holds the dominant position in the construction project, delays the payment of project prices, while the contractor, as the main implementer of the construction project, faces the problem of not being able to recover the project prices in time, resulting in difficulties in the operation of the enterprise and affecting the payment of workers' wages, causing social livelihood problems. During the compilation of the Civil Code, the current normative text of Article 807

inherited and developed the legislative spirit of the original Contract Law Article 286, breaking the traditional principle of equal creditor rights, providing the contractor with legal priority protection, and granting the contractor the priority compensation right for project prices.

The theoretical community has analyzed this issue from different perspectives, attempting to find solutions. For example, Fang Weilun's "Parachute Effect" theory suggests that if the design is improper or the interpretation is inappropriate, it may deviate from the legislative intention and lead to reverse distribution or induce moral risks. The legislative purpose of the construction priority right is to protect the interests of construction workers, especially the interests of migrant workers. In terms of a legal intervention to protect the interests of vulnerable groups, market feedback may be an "amplifier" or may create a "parachute"<sup>[1]</sup>.

## **2. Judicial application dilemmas of the priority compensation right for construction project prices**

### **2.1. Subject qualification determination dilemma**

The prerequisite for exercising the priority compensation right is the qualified subject. Article 807 of the Civil Code defines the subject as the contractor, but the subjects in the construction project contract relationship are not simply the contractor that can be generalized. In practice, there are continuous disputes over the subject qualification, mainly focusing on three types of subjects: actual constructors, subcontractors, and contractors with invalid contracts.

(1) The rights position of actual constructors. In judicial practice, the attitude of courts in making judgments is polarized: some courts strictly adhere to the principle of contract relativity and deny the subject qualification of actual constructors, while other courts, from the perspective of fairness and protection of workers' rights, support the actual constructors in claiming the priority right within the amount of unpaid project prices.

At the same time, academic viewpoints are also highly opposed. Yang Shaoyu advocates that the "contractor" in Article 807 of the Civil Code should be expanded. The contractor refers to the party that actually fulfills the obligation of construction. When the actual constructor and the nominal contractor both claim the priority compensation right in a construction project contract dispute, the actual constructor should enjoy it<sup>[2]</sup>.

However, the negative view emphasizes that the principle of contract relativity cannot be broken. Cui Jianyuan believes that the priority compensation right for construction project prices is a legal guarantee right, and its basis is the construction project contract relationship. If the principle of contract relativity is broken, there needs to be a sufficient normative basis and policy reasons<sup>[3]</sup>.

(2) The ambiguity of the subject qualification of subcontractors. The legal subcontractor forms a creditor-debtor relationship with the contractor based on the subcontracting contract, but has no direct contractual relationship with the employer. Therefore, in principle, it does not possess the qualification of a priority claimant. However, in practice, there are sometimes special circumstances, such as the employer designating the subcontractor, making direct payments, or conducting direct acceptance, where the subcontractor actually assumes the role of the contractor. At this point, whether to grant it priority rights lacks a clear regulatory basis, leading to inconsistent judicial decisions.

(3) Disagreements over the qualification of the parties in cases of invalid contracts. The judicial interpretation clearly states that the contractor can claim the project payment when the quality of the

project is qualified. However, there are disputes in theory and practice regarding whether the invalidity of the contract affects the exercise of priority rights. Wang Weiling pointed out that the priority right of construction project compensation is a legal breakthrough of the equality of creditor rights, which is of great significance to the interests of third parties. It must have a sufficient legitimacy basis. Although the purpose of establishing this system is to protect the interests of the contractor, it does not mean that the contractor still enjoys the priority right of construction project compensation when the contract is invalid<sup>[4]</sup>.

## **2.2. Unclear boundaries of the priority compensation scope**

The priority compensation scope is the focus of the negotiation between the contractor and other creditors, directly determining the content of the contractor's rights. The existing judicial interpretation stipulates that the priority scope is determined based on the regulations of administrative authorities, resulting in the priority scope not including interest, penalty, and damages, but there is considerable controversy in practice.

- (1) Whether profits should be included in the priority scope. Usually, the project payment consists of costs, profits, taxes, etc., among which profits are the reasonable return of the contractor's business activities. However, some courts believe that the priority right aims to protect the wages of workers, material payments, etc., which are direct expenditures, while profits belong to operating income and should not be included in the priority scope; conversely, some courts believe that profits belong to the legal composition of the project payment and should be prioritarily compensated.
- (2) The nature of the suspension loss is unclear. The suspension loss caused by the employer's reasons, including labor costs, machinery rental fees, material storage fees, etc., is an actual expenditure or a breach of contract loss. The existing judicial interpretation does not clearly define whether this is an actual expenditure or a breach of contract loss.
- (3) The applicable scope of decoration and renovation projects is unclear. Although the existing judicial interpretation recognizes the priority right of the contractor for the construction project of business operation, the decoration and renovation of family residences, ancillary facilities, and landscaping projects are not applicable, and there is a lack of clear standards, resulting in inconsistent application standards in practice.

## **2.3. Difficulties in applying the requirements for exercising the procedure**

- (1) The issue of the start of the limitation period. Article 41 of the Construction Industry Judicial Interpretation stipulates that the exercise period is 18 months, which is of the nature of a limitation period and does not apply to suspension, interruption, or extension. However, the starting point is the date when the employer should pay the project payment. Although this rule extends the protection period of rights, the determination of the starting point is extremely difficult. First, for unfinished projects and unfinished projects, the starting point. In practice, some take the agreed completion date in the contract as the starting point, some take the suspension date as the starting point, and some take the date of filing as the starting point. Second, for uncompleted projects. The contractor usually claims that the period has not started due to non-settlement, while the employer claims that it should be calculated strictly according to the payment time stipulated in the contract. Third, for the starting rule in cases of installment payment of project funds. When the contract stipulates installment payment, the priority right is calculated separately from each installment due date, or from the last installment. Due to the

contractor's inability to accurately grasp the exercise time, the right is lost upon the expiration of the period.

- (2) The requirements for the notice procedure are unclear. Article 807 of the Civil Code requires that the contractor must first notify the employer within a reasonable period before requesting the court to auction the construction project. The design intention of this pre-procedure is to give the employer one last opportunity to perform, avoiding directly entering the judicial auction procedure and increasing transaction costs. However, the law does not clearly define the form, content, and specific length of the "reasonable period". This article holds that as long as the employer has obtained a reasonable opportunity for payment before the judicial process is initiated, the formal flaws of the notice procedure should be correctable.

#### **2.4. Lack of a conflict resolution mechanism for power**

During the exercise of the priority right to claim for project payment, it is inevitable to conflict with mortgage rights, the rights of home buyers, and ordinary debts. Although the existing regulations determine the basic sequence, they lack a complete conflict resolution mechanism, resulting in an imbalance of interests. Firstly, the priority right of the contractor conflicts most typically with mortgage rights. Currently, there is a lack of unified system design, leading to an intensified opposition of interests between mortgage creditors and contractors. Secondly, the priority right of the contractor conflicts with the rights of home buyers without detailed standards. In practice, the phenomenon of developers and home buyers colluding maliciously to harm the interests of contractors still exists in large quantities. Finally, the coordination between the priority right of the contractor and ordinary debts, as well as the rights of actual contractors, is insufficient. The imbalance of interests brought about by legal intervention is prone to a boomerang effect, not only failing to fully protect the contractor but also triggering new conflicts of interest.

### **3. Improving the path of the construction project payment priority right**

#### **3.1. Clarify the qualification standards and unify the judicial judgment scale**

Firstly, classify and define the rights of actual contractors. When the general contractor neglects to exercise the priority right and harms the interests of actual contractors, the actual contractors should be allowed to claim the right on their behalf; in the case of subcontracting, the subcontractor who actually invests funds and labor should be granted priority rights; in the cases of subcontracting and illegal subcontracting, the actual contractors can claim the priority rights within the scope of the employer's unpaid project payment.

Secondly, clarify the boundary of the subcontractor's rights. Generally, the subcontractor does not enjoy the priority right, but when the employer designates the subcontractor, makes direct payment, or confirms the subcontract contract in writing, the subcontractor can claim the priority rights for the part of the construction; the illegal subcontractor does not enjoy the priority right, and can only claim ordinary debts.

Finally, unify the rights rules when the contract is invalid. Whether the contract is valid or not, as long as the project quality is qualified, the contractor enjoys the priority right; if the project quality is unqualified and cannot be repaired, the contractor cannot claim the right. This rule respects the value of labor and also takes into account the interests of the employer, which can effectively unify judicial judgment.

### **3.2. Specify the scope of priority compensation and eliminate practical differences**

Firstly, clearly include the cost, profit, taxes, and fees in the priority scope. Profit belongs to the reasonable operating returns of the contractor and should be included in the priority scope; at the same time, interest, penalty, and expected losses should be excluded to prevent excessive expansion of the priority right and damage to the interests of other creditors.

Secondly, distinguish the nature of the suspension loss. The actual expenditures, such as labor, machinery, and materials, due to the employer's reasons, should be included in the priority scope; expected loss and punitive compensation should be excluded, achieving a balance of interests.

Thirdly, define the applicable boundary of decoration and renovation projects. If the operating decoration project has the conditions for auction, the contractor enjoys the priority right; household decoration, greening projects, and ancillary facilities projects are not applicable to the priority right, to avoid the abuse of rights.

### **3.3. Optimize the exercise period rules and ensure the normal exercise of rights**

Firstly, detail the starting point of special circumstances. For unfinished projects and projects with suspension in the middle, the starting point is the date of contract termination or the actual suspension date; for unsettled projects, the starting point is the date of contract payment or the date of acceptance and qualification; for phased payment projects, the starting point is the date of the last installment payment.

Secondly, clarify the exercise method. Agreement on discount, application for auction, lawsuit, arbitration, and written notice are all legal exercise methods. If the contractor files a lawsuit or initiates arbitration within the time limit, it is regarded as the right having been exercised, and there is no need to separately claim the priority position, reducing the threshold for exercising the right.

Thirdly, add an exception for extension of the period. Due to force majeure, the employer's malicious delay in settlement, policy adjustments, etc., which are not attributable to the contractor, resulting in the expiration of the period, the period can be appropriately extended, balancing the protection of rights and transaction security.

### **3.4. Establish a mechanism for balancing diverse interests and resolving rights conflicts**

Firstly, improve the coordination rules for priority rights and mortgage rights. Implement a simplified registration system for priority rights to reduce information asymmetry. The mortgagee of real estate only needs to prove that there is an error in the effective judgment, that the effective judgment poses a risk or possibility of harming the mortgage right, to meet the conditions for the third party's rescission lawsuit<sup>[5]</sup>.

Secondly, refine the rules for protecting the rights of consumers and home buyers. "For the purpose of residence" is limited to meeting the basic living needs for residence, and has no necessary relationship with the type and quantity of the purchased house. "Full payment" mainly includes full payment and mortgage payment. "The house cannot be delivered" refers to the fact that the commercial housing has not passed the completion acceptance and qualification, while "the house has no possibility of actual delivery" needs to be determined comprehensively based on the project progress and the operating status of the developer<sup>[6]</sup>.

## **4. Conclusion**

The construction project price priority compensation right system carries multiple values, such as protecting the rights of contractors, protecting the interests of workers, and regulating the construction market order. It

is an indispensable important system in China's construction law system. With the continuous changes in the construction market model, the system continues to face new challenges in terms of subject identification, priority scope, exercise period, and conflict resolution. There are differences in theoretical viewpoints, and judgments in practice vary. There is still a certain deviation between the operational effect of the system and the legislative intention.

This paper, by sorting out the legal basis of the system, analyzing the multiple dilemmas in practice, analyzing the interest game among various subjects, and proposing systematic improvement suggestions from the dimensions of subjects, scope, period, conflict resolution, and supporting mechanisms, aims to bridge the gap between norms and practice and promote the standardized operation of the system. In the future, it is necessary to continuously optimize judicial interpretation rules, improve industry supervision, and achieve the unity of legal effect, social effect, and industry effect by combining with the development dynamics of the construction market.

## Disclosure statement

The author declares no conflict of interest.

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