Legal Issues on Mortgages in China

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In China, mortgageable property mainly includes land use rights, buildings and other attachments to land, vessels, aircraft, vehicles, machinery and other moveables.[1] Mortgages are generally required to be created by the owners of the property. However, according to the provisions of the *Security Law*, if a mortgaged property is state-owned, it need not be necessarily be owned by the mortgagor. It is sufficient that such state-owned property be that which the mortgagor 'has the right to dispose of according to law'. Such provisions enable state-owned enterprises to create mortgages over assets which they do not own but have the right to dispose of according to law.

Real Property Mortgage

Buildings in China are divided into many types. Some of them may only be sold in overseas markets, others to domestic persons, and yet others only to special domestic persons. Therefore, a mortgagee should carefully examine the restrictions on a sale of a building before agreeing to take a mortgage over the building.

In accordance with Chinese law, where a building is mortgaged, the right to use the land where the building is erected shall be mortgaged simultaneously.[2] There are only two kinds of land ownership in China, namely state ownership and collective ownership. Land in cities is owned by the state, and land in rural and suburban areas by collectives, except for those portions which belong to the state by law.[3] In China, the ownership of land may not be mortgaged. However, China practices the principle of separating the ownership of land from the right to use land.[4] Land use rights in China can be divided into three kinds: the granted land use right, the allocated land use right and the collective land use right.

Granted Land Use Rights

The granted land use right refers to the state-owned land use right granted by the state to the land user for a period of land use in consideration of a grant fee paid by the land user. This kind of land use right can be mortgaged. At the time of mortgage, if there is a building on the land, the building shall be mortgaged simultaneously.[5] However, before a lender accepts a mortgage over the granted land use right, the lender should first examine whether the conditions for such land use being transferrable have all been fulfilled. If they have not been fulfilled, even if such granted land use right is mortgaged to the lender, the lender may be unable to sell or transfer such right in exercise of its right as mortgagee. According to Chinese law, the granted land use right may not be transferred unless all the following conditions have been fulfilled:

- the grant fee for the land use right has been fully paid in accordance with the grant contract, and the land use certificate has been obtained; and
- investment and development have been carried out in accordance with the grant contract. Where the investment is for the construction of buildings, more than 25 per cent of the total amount of investment must already have been made. Where the investment is for the development of a large tract of land, conditions for the land to be used for industrial or other construction purposes should have already been created. Where buildings on the land have been completed at the time of transfer, the real estate title certificate for the buildings should already have been obtained.[6]

Allocated land Use Rights

The allocated land use right refers to the state land use right allocated by the state to the land user without consideration (although sometimes the land user may be required to pay resettlement subsidies). According to Chinese law, the allocated land use right may be mortgaged together with the completed building located on the land. However, when the mortgagee disposes of the building together with the allocated land use right, where the competent government authority has given its approval that prc dures for the grant of land use right n not be carried out, the transferor sl submit to the state such amount from proceeds of the real property tran: which is attributable to the land. Ot wise, the procedures for the grant of lε use right must be carried out, and con quentially, the grant fee must be paid the transferee. It should be noted t except for the stipulation that the gran land use right can be mortgaged, ther no stipulation that the allocated land ι right can be mortgaged where no co pleted building has been erected on t land.[7]

Collective Land Use Rights

According to the *Security Law* t collective land use right may only mortgaged in the following circur stances:

- where the collective land use right mortgaged together with the factoı buildings of townships and villag erected on such land; and
- where the mortgagor has consente to the mortgage of the right to us collectively owned wasteland suc as barren hills, gullies, mound: beaches etc.[8]

The transfer of the collective land us right is subject to strict control. Whe state-owned enterprises or units, urbaı collective enterprises or units, or thos enterprises with foreign investment nee to use collective land, they have to appl for approval for the state to expropriat the collective land and convert it int state land first, and then obtain the righ to use state land from the state by way o grant or allocation.[9] Therefore, if mortgaged property involves the collective land use right, it will be relatively difficult for a mortgagee to dispose of the mortgaged property. Further, a mortgagee will often be required to pay a grant fee for such disposal.

Mortgage over Future Property

The *Security Law* is based on the principle that a mortgage should be created over the mortgagor's existing prop-

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erty, and a mortgage over future property is not recognised.[10]

Where local regulations conflict with the *Security Law*, the *Security Law* will prevail since the *Security Law* is a national law and takes precedence over local regulations.

However, the *Security Law* is silent as to the validity of mortgages over real property created in accordance with local mortgage regulations before the promulgation of the *Security Law*. This question has to be answered through legislative or judicial interpretations.

Maximum Amount Mortgage

The maximum amount mortgage is defined as a special mortgage whereby a mortgage is created over an asset to secure a series of debts over a certain period of time up to a maximum amount. A maximum amount mortgage is different from an all-moneys security.

To constitute a maximum amount mortgage, it is not sufficient that there is a series of contingent debts. There must be an express debt limit which should be contained in a principal contract. A maximum amount mortgage contract should be attached to a principal contract, which, according to the *Security Law*, may be a loan agreement or a contract for a series of commodity transactions over a certain period.[11]

It should be noted that there is an important difference between a maximum amount mortgage and an ordinary mortgage. The *Security Law* states that under a maximum amount mortgage, the creditor's rights under the principal contract may not be assigned, whereas under ordinary mortgage, the *Security Law* does not prohibit the assignment of the creditor's right under the principal contract if such assignment is made together with the mortgagee's right.[12]

Registration of Mortgaged Property

Mortgages created over any of the following property must be registered with the relevant authorities failing which the mortgages will be ineffective:

- mortgages over rights to use land (to which there are no attachments) must be registered with the land administration authority which issued the land use certificate;
- mortgages over urban real property, or a factory building of a township or village must be registered with the authority designated by the local government or at above county level;
- mortgages over aircraft, vessels or vehicles must be registered with the registry for means of transportation;
- mortgages over equipment or other movables of an enterprise must be registered with the local administrative bureau for industry and commerce.

Mortgages over property other than the aforesaid will come into force on the date of execution. In such cases, the parties may voluntarily register mortgages, failing which the mortgagee may not be able to enforce his rights against third parties.[13]

Enforcement of Mortgagee's Rights

The *Security Law*, the *Enterprise Bankruptcy Law (Trial Implementation)* and the *Civil Procedure Law*, as well as related judicial interpretations, all give mortgagees priority in receiving payment from the disposal of mortgaged property.[14] However, the *Security Law* states that a mortgagee and a mortgagor may contract that the mortgaged property shall not be disposed of when the mortgagee is not duly paid.[15] The obvious reason for such a condition is that the mortgaged property may be worth more than the secured debt.

The *Security Law* states that the mortgagee may agree with the mortgagor to receive payment by converting the mortgaged property into value, or sale of the mortgaged property. If such agreement cannot be reached, the mortgagee may take the matter to the People's Court.[16] Note that the *Security Law* does not state that the mortgagee may convert the mortgaged property into value or dispose of the mortgaged property without the mortgagor's consent.

According to the *Commercial Bank Law*, although commercial banks are prohibited from engaging in trust investment, stock operation and investing in real property which is not for their own use, for the purpose of exercising their rights as mortgagees, commercial banks may own immovable property or shares. However, such immovable property or shares have to be disposed of within one year from the date on which they are obtained.[17]

Where the same property is mortgaged to two or more creditors, priority is given in order of registration. If registration of the mortgages is optional and they are not registered, priority is given in the order of execution of the mortgage contracts. Where two or more mortgages have been registered at the same time, payment shall be made according to then proportion of the debt. A registered mortgage will take priority over an unregistered mortgage.[18]

END NOTES

1. Article 34 of the *Security Law*.
2. Article 36 of the *Security Law*; art 47 of the *Law on the Administration of Urban Real Estate* (LAURE); art 33 of the *Provisional Regulations on the Grant and Transfer of the Right to Use Urban State Land* enacted on 19 May 1990.
3. Article 10 of the *Constitution Law*; art 2, 6 of the *Land Administration Law*.
4. Article 37(1) of the *Security Law*; art 2 of the *Provisional Regulations on the Grant and Transfer of the Right to Use Urban State Land*.
5. Article 7 of the LAURE; art 36(2) of the *Security Law*.
6. Articles 37(1) and 38 of the LAURE; art 3(4), 6(1), and 10 of the *Administration Regulations on the Transfer of Urban Real Estate* enacted on 7 August 1995.
7. Article 22, 47 and 50 of the LAURE; art 56 of the *Security Law*; art 3(4), 11 and 12 of the *Administration Regulations on the Transfer of Urban Real Estate*.
8. Article 37(2) of the *Security Law*.
9. Chapter 4 of the *Land Administration Law*; art 8 of the LAURE; paras 2 and 4 of the Notice on the Administration of the Land Use by Foreign Investment Enterprises issued by the State Land Administrative Bureau in October 1987.
10. Article 55 of the *Security Law*.
11. Articles 59 and 60 of the *Security Law*.
12. Articles 61 and 50 of the *Security Law*.
13. Articles 41–43 of the *Security Law*.
14. Article 33(1) of the *Security Law*; art 32 of the *Enterprise Bankruptcy Law (Trial Implementation)*; art 203 of the *Civil Procedure Law*.
15. Article 40 of the *Security Law*.
16. Article 53 of the *Security Law*.
17. Articles 42 and 43 of the *Commercial Banking Law*.
18. Article 54 of the *Security Law*.