

# Legal issues on Pledges and Accounts Receivable in China

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Under the provisions of *Security Law* in the People's Republic of China, pledges can generally be categorised into two groups: pledge of movables and pledge of rights.

## Pledge of Movables

The primary difference between a pledge of movables and a mortgage of movables is that a pledge entails the transfer of possession of the pledged movables from the pledgor to the pledgee. The *Security Law* provides that the pledgor and pledgee shall conclude a written pledge contract which shall become effective upon the transfer of possession of the pledged property in proper custody.<sup>1</sup> In cases where it is not convenient for a creditor to take possession of movables, the creditor may prefer to take security for the debt owed by way of a mortgage over the movables. A mortgage is non-possessory in nature but requires registration with the relevant authorities.

There is no equivalent concept of the floating charge under Chinese laws and regulations. There is also no legal basis in China for pledge over future movables.

## Pledge of Rights

The following instruments and rights may be pledged:

- bills of exchange, cheques, promissory notes, bonds, certificates of deposits, warehouse receipts, and bills of lading;
- shares and share certificates that are transferrable according to law;
- other rights that may be pledged according to law.<sup>2</sup>

Pledges of bills of exchange, cheques, promissory notes, bonds, warehouse receipts and bills of lading become effective on the date of delivery to the pledgee of the documents of title.<sup>3</sup> The proper endorsement of the pledge by the pledgor is also required for the effective pledge of bills of exchange, cheques and promissory notes.<sup>4</sup>

Where transferable shares in a com-

pany limited by shares are pledged, the parties must enter into a written contract which will become the date of registration of the pledge with the register of shareholders.<sup>5</sup> Shares in a company limited by shares cannot be pledged if such shares are not transferable.

Generally speaking, although shares in a company limited by shares may be transferred freely by the shareholder, there is still a number of legal restrictions on such transfer. For example, shares in a company limited by shares held by the company's promoters cannot be transferred within three years from the date of establishment of the company.<sup>6</sup> State owned shares may not be transferred unless prior approval has been obtained from the relevant government authority in charge of the administration of state-owned assets.<sup>7</sup> Foreign shares in a company listed on a Chinese stock exchange may only be purchased and traded by foreign companies and individuals as well as overseas Chinese.<sup>8</sup>

Where shares in a limited liability company are pledged, the relevant provisions of the *Company Law* in respect of transfer of shares are applicable. The pledge contract will become effective on the date on which the pledge of the shares is recorded in the register of shareholders.<sup>9</sup> According to the *Company Law* and the other relevant laws, a shareholder of a limited liability is rather restricted in the transfer of his shares. Take a Sino-foreign equity joint venture, for example. If one party to an equity joint venture wants to transfer its shares in the registered capital of the joint venture, the other party's consent, unanimous approval of the board of directors of the joint venture company and approval from the examination and approval authority must be obtained.<sup>10</sup> As such, if a lender accepts a pledge of shares in a Sino-foreign equity joint venture, it should request a unanimous board resolution of the joint venture company, written consent from the other

joint venture parties and a written consent from the examination and approval authority.

## Enforcement of a Pledgee's Right

Under the relevant Chinese laws, a pledgee has priority in receiving payment from the disposal of pledged property. Similar to the regulations for mortgage contracts, the *Security Law* also prohibits parties from stipulating in pledge contracts that pledged property will be transferred to the pledgee in the event of a default in payment.<sup>11</sup>

As to enforcement of a pledgee's right, the *Security Law* provides that 'where a pledgee has not received full payment at the expiration of the term for payment for payment of the secured debt, the pledgee may agree with the pledgor to convert the pledged property into value or the pledgee may auction or sell the pledged property.'<sup>12</sup>

In contrast to the enforcement of a mortgagee's rights, a pledgee may auction or sell the pledged property without first obtaining the pledgor's consent.

## Assignment of Accounts Receivable

In China, accounts receivable may, with the consent of the debtor, be assigned by the beneficiary to a third party.<sup>13</sup> However, since there is no legal stipulation in China dealing with assignments as security, the procedure by which accounts receivable are assigned in common law countries may have to be adjusted for use in China. The following issues would be pertinent to a creditor:

- **Notice to the Debtor.** Rights under a contract cannot be assigned to a third party unless both parties to that contract consent in writing to the assignment.
- **Approval by the Original Approval Authority.** If a contract is required to be approved by a competent authority, the assignment of the rights and obligations under that contract must also be approved by the original approval authority un-

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less otherwise provided for in the contract.<sup>14</sup>

- **Future Rights.** In China, there is no legal basis for the assignments of future rights.
- **Escrow Account.** In common law countries, it is not unusual to provide in an assignment agreement that the assigned revenues and proceeds receivable be paid into an escrow account opened in the name of the assignor, and for the assignee to take charge over the account. In China, bank accounts may not be charged, mortgaged or pledged. Even if an assignee is authorised to draw from the escrow account, he will have no priority should the assignor become insolvent. Therefore, an alternative is to have the assigned revenues and proceeds receivable paid directly to the assignee's account.

## **Impact of Invalidity of Principal Contract.**

In China, it is common to provide in a security contract that the security created is not only for securing the performance of the borrower's obligations under the loan agreement, but also for indemnifying the lender from all losses and liabilities incurred as a result of the invalidity or unenforceability of the loan agreement.

As to a guarantor's liability after the principal loan agreement has been held void, the Chinese Supreme Court held in 1988 that if the principal debtor is held liable for the refund of the loan, the guarantor will still be jointly and severally liable unless the parties had agreed otherwise.<sup>15</sup> However, it was subsequently held in 1994 by the same Supreme Court that a guarantor may refuse to assume joint and several liability for damages after the principal contract is held void unless it can be shown the guarantor had given the guarantee with knowledge of the invalidity of the principal contract.<sup>16</sup>

According to the *Security Law*, the scope of security covers the principal obligations, interest, liquidated damages, compensation damages and costs for realising the security, and in the case of

a pledge, custody expenses. The *Security Law* also provides that the parties may expressly set out in the contract the scope of the security and that such agreement will prevail over the provisions of the *Security Law*. As such, although the *Security Law* states that the security shall be extinguished if the secured obligation is extinguished, it does not prohibit the parties from stipulating the scope of the security in a security contract. It seems, therefore, that the parties may agree that the obligations secured shall include both the borrower's obligation to pay the principal debt under the principal contract and the borrower's obligation to refund and make compensation if the principal contract is held void.<sup>17</sup> This seems to mean that, if the parties agree, a security can include both security obligations based on the principal contract and indemnity obligations if the principal contract is held void.

Obviously the indemnity obligations are binding only if the security contract is still effective after the principal contract is held void. Article 5 of the *Security Law* states: 'A security contract shall be accessory to the principal contract, and shall be invalid if the principle contract is invalid, provided, however that if a provision to the contrary is contained in the security contract, such provision shall prevail'.

The proviso seems to give the parties room to insert in the security contract clauses providing that the indemnity obligations are primary and will remain in force notwithstanding the invalidity of the loan agreement. However, whether such clauses will be enforceable will nevertheless be subject to the interpretation of the Chinese legislative body or judicial authority.

## **Subrogation and Subordination**

The *General Principles of Civil Law*, the *Security Law* as well as other relevant laws all give a guarantor the right of subrogation.<sup>18</sup> That is to say, a guarantor who has performed to guarantee obligations (even partially) will have recourse against the borrower, or a right to claim rateable contribution from other joint and several guarantors. Similarly,

the *Security Law* provides that a mortgagor or pledgor will have recourse against the borrower after realisation of the security by the lender.<sup>19</sup>

Due to the right of subrogation, a lender who has not been fully paid will have to share pro rata any sum he receives from the liquidation of the borrower's assets with parties who have assumed security liability under security contracts. It is therefore important for lenders to exclude such subrogation rights from security contract and to exclude provisions stating that all claims under security contracts are subordinated to the claims of the lender until he is fully paid.

## **Governing Law and Jurisdiction**

Some security contracts are required to be governed by Chinese law, a mortgage over real property is situated.<sup>20</sup>

According to the judicial interpretations of the Supreme Court, parties may not choose a foreign court to adjudicate a dispute if the dispute is subject to the exclusive jurisdiction of the Chinese court. For example, a dispute concerning real estate is subject to the exclusive jurisdiction of the Chinese court in the place where the real estate is located.<sup>21</sup>

Except for contracts which must be governed by Chinese law and disputes which must be subject to the jurisdiction of a Chinese court, the parties to a security contract involving foreign interests may select a foreign law as the governing law and select a foreign court as the jurisdictional court. From a foreign lender's perspective it is most convenient to select a familiar foreign law as the governing law and to select a court in the foreign lender's home country as the jurisdictional court.

However, foreign lenders should note the limitations of such choices. First of all, a judgment of a foreign court may not be directly enforceable in China. Such a judgment has to be reviewed by a Chinese court in accordance with the principles of international treaties entered into or acceded to by China, or in accordance with the principle of reci-

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procuity. The foreign judgment may only be enforced in China if the court finds that such judgment 'does not violate the basic principles of the laws of the PRC and its sovereignty, security or social and public interest', and makes a ruling recognising its validity and issues an enforcement order.<sup>22</sup>

According to the judicial interpretation of the Chinese Supreme Court, the applicable foreign law may be ascertained via the following ways:

- through the parties;
- through the central authority of the foreign country which entered into or acceded to a judicial assistance international treaty with China;
- through the Chinese embassy or consulate in such a foreign country;
- through the embassy of such foreign country in the PRC;
- through legal experts from China and such foreign country.

In accordance with the judicial interpretations of the Supreme Court, the relevant Chinese laws will apply if the foreign law cannot be ascertained.

Furthermore, if the application of a foreign law will result in the violation of the basic principles of Chinese law and social public interest, or if the selection of foreign law as the governing law is for the purpose of evading mandatory or prohibitory Chinese regulations, then such foreign law will not apply and the relevant Chinese law will apply.<sup>23</sup>

Presently, there are quite a number of regulations pertaining to banking security, many of which may be interpreted as 'mandatory or prohibitory', or as relating to 'the basic principles of Chinese law and social public interest'. Therefore it may be concluded that even if the parties to a security contract select a foreign law as the governing law, and a foreign court as the jurisdictional court, Chinese legal stipulations and requirements should not be ignored if the security is to be enforced or realised in China.

## ENDNOTES

1. Articles 63, 64 and 69 of the *Security Law*.

2. Article 75 of the *Security Law*.
3. Article 76 of the *Security Law*.
4. Articles 35 (2), 81 and 94 of the *Negotiable Instruments Law*.
5. Article 78 (1) of the *Security Law*.
6. Article 147 of the *Company Law*, art 8 of the *Provisional Regulations on Several Issues concerning the Establishment of Foreign Companies Limited by Shares*.
7. Article 19 of the *Provisional Regulations on Administration of State Owned Assets in Trial Share Formulated Enterprises*.
8. Article 4 of the *Regulations on Foreign Shares of the Company Limited by Shares Listed within the Territory of the PRC*.
9. Article 78 (3) of the *Security Law*.
10. Articles 35 and 18 of the *Company Law*, art 4 of the *Law on Sino-foreign Equity Joint Venture Enterprises*.
11. Articles 53, 66 and 81 of the *Security Law*.
12. Article 71 (2) of the *Security Law*.
13. Article 91 of the *General Principles of Civil Law*, art 26 of the *Foreign Economic Contract Law*.
14. Article 91 of the *General Principles of Civil Law*, art 27 of the *Foreign Economic Contract Law*.
15. Article 11 of the *Opinion of the Supreme People's Court on Several Issues Relating to Implementation of the PRC General Principles of Civil Law (Trial Implementation)*.
16. Article 20 of the *Provisions of the Supreme People's Court on Several Issues relating to Guaranteed in respect of Trial of Economic Contract Disputes*.
17. Articles 21, 46, 67, 52, and 74 of the *Security Law*.
18. Article 89 (1) of the *General Principles of Civil Law*, art 31 and 32 of the *Security Law*.
19. Articles 57 and 72 of the *Security Law*.
20. Article 144 of the *General Principles of Civil Law*.
21. Articles 34 and 244 of the *Civil Procedure Law*.
22. Article 268 of the *Civil Procedure Law*.
23. Article 150 of the *General Principles of Civil Law*.

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