TOWARDS A MARKET ECONOMY: SECURITY DEVICES IN CHINA

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Abstract: From 1949 to 1978, China's economy was centrally directed under a very rigid system of state planning. Under the planning system, security devices were not widely used. The government drew specific plans for enterprises and the Ministry of Finance used banks to allocate the funds to enterprises or projects. The banks, however, did not have to screen projects and monitor the use of funds after disbursements. They merely distributed the money to enterprises and collected the profits. Recognizing the shortcomings of central planning based almost exclusively on public ownership over the means of production, China embarked on an economic reform program in 1978. In 1993, China boldly declared that it would move towards a market oriented economy. Security devices have played significant roles in China's reform towards a market oriented economy. Within a period of twenty years, China has developed a sophisticated understanding of the many security devices adopted in the West. Secured transactions are now very popular. The central focus of this article is to examine the various security devices under Chinese law and practice. These security devices include the deposit, the lien, the di'an, the mortgage, the pledge, and the guarantee. The strengths and weaknesses of the legal provisions governing these security devices are also discussed. As China does not fully guarantee the convertibility of its currency into foreign currencies, a separate discussion concerning the provision of security or guarantee to foreign entities is provided.

I. INTRODUCTION

From 1949 to 1978, the economy of the People's Republic of China (“China” or “PRC”) was centrally directed under a very rigid system of state planning. Within this system, the state owned most of the productive resources, leaving only a minor portion in the hands of enterprises (normally in collective ownership). The state controlled the macroeconomic decision-making power as well as the major activities of enterprises. Although a market economy existed, since currency commodity relations remained, the state hierarchy made plans to ensure that enterprises would realize various
mandatory targets. As fiscal agents of the government, the only role played by banks was to implement state plans. Given that banks did not have to screen projects and monitor the use of funds after the fact, the constraints on enterprises were quite soft.

The enterprises immediately responsible for production had to follow state orders in many activities, including finance, management, marketing, employment, wage policy, and expansion; consequently, they enjoyed little independence. As the economic benefits of enterprises were not linked with their performance, enterprises with significant profits had no right to dispose of their profits, while enterprises operating with heavy losses were subsidized by the state. The Ministry of Finance distributed all budgetary allocations and collected all enterprise surpluses through the People's Bank of China. Economic information was transmitted vertically between the higher and lower levels in the administrative system in the form of instructions and reports. Within such a system, there was no need to have security devices for credit transactions.

Recognizing the shortcomings of central planning principally based on public ownership over the means of production, China embarked on an economic reform program in 1978. This economic reform began in rural areas where a contractual responsibility system was adopted. Except for some state quotas on products such as rice, wheat, and oil seeds, this contractual responsibility system granted farmers the flexibility to choose what kind of produce to grow; as a result, farmers could sell many agricultural products on the market. As more agricultural products were traded, the role of the agricultural market increased. Also, as of 1978, urban enterprises were given more autonomy in managing their own affairs. Enterprises were

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3 See generally JANOS KORNAI, ECONOMICS OF SHORTAGE (1980) for a discussion about soft budget constraints.
4 For an historical overview of China's state-owned enterprises, see Jiang Qiangui, Like Wading Across a Stream: Law, Reform and the State Enterprise, in COMMERCIAL LAW IN THE PEOPLE'S REPUBLIC OF CHINA (Bryan Bachner & Hualing Fu eds., 1995).
5 See Wu Xiaoling, China's Financial Institutions, in FINANCIAL REFORM IN CHINA 113 (On Kit Tam ed., 1995).
6 Interview with Jiang Qiangui, former official with the Ministry of Foreign Trade and Economic Cooperation (July 1994).
7 In late 1978, China's economic reform and open-door policies were initiated at the Third Plenary Session of the Eleventh Chinese Communist Party Congress. For an overview of China's economic reform, see generally HARRY HARDING, CHINA'S SECOND REVOLUTION: REFORM AFTER MAO (1987).
8 See Jiang Qiangui, supra note 4, at 2.
9 Id.
10 Id.
11 Id.
allowed to retain a portion of their profits. Reform measures also included permission for private investment by both domestic investors and foreign investors, liberalization of the economy through decentralization, and the establishment of market institutions.

The change in how productive projects are financed has been central to the enterprise reform program. There are two main channels for financing enterprise projects: equity financing and debt financing. Equity financing allows enterprises to issue shares and other securities. Although there were 761 companies listed on the Shanghai Stock Exchange and the Shenzhen Stock Exchange at the end of February 1998 and more than 30,000 joint stock companies in 1998, equity financing is still relatively less significant than debt financing. Debt financing from the major specialized banks bears the main burden of China's commercial financing and will remain significant for some time. A vital method of financial reform has been to replace governmental fund allocation with bank loans.

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12 Id.
15 An example of decentralization is the decision to establish three special economic zones in Guangdong province in 1980. The local governments in the zones were given a great deal of autonomy related to foreign trade and investment. The establishment of market institutions included the labor market established soon after direct foreign investment was allowed in 1979 and the capital market established at the end of the 1980s. Guandong Sheng Jingji Tequ Tiaoli [Regulation of Special Economic Zones in Guangdong Province] (1980), reprinted in COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, supra note 13, at 68. The regulation authorizes the establishment of special economic zones and grants the powers to the Special Economic Zones Management Commission of the Guangdong Province to manage these zones. The Joint Venture Law allows joint ventures to hire and dismiss employees through contractual arrangements. Joint Venture Law, art. 6. Before that, dismissal of employees was almost impossible. Qiye Zhaipiao Guanli Zanxing Tiaoli [Provisional Regulations on the Administration of Enterprise Bonds] (1987), reprinted in COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, supra note 13, at 791. These regulations were a step towards establishing the capital market in China.
16 Prior to 1979, the methods of raising and utilizing funds were extremely simple. There were only two types of transactions: deposit and credit. Shares and bonds were considered too capitalistic and were banned. See Wu Xiaoling, supra note 5, at 116.
19 All the listed companies have raised a total of 279 billion yuan by the end of 1997. In contrast, deposits in state banks are around 800 billion yuan at the beginning of 1998. See Dong Jian, China to Introduce Deposit Insurance System, CHINA ECON. NEWS, May 25, 1998.
20 Zhou Zhengqing, Explanations Concerning the Commercial Banking Law of the People's Republic of China, Address at the Thirteenth Session of the Eighth Standing Committee of the National
Financial reform in China has mainly occurred by reforming the banking sector. In 1978, there were only two banks in China: the People’s Bank of China, engaged in domestic banking, and the Bank of China, which dealt with foreign currency business. Beginning in 1979, China reconstructed the previously dissolved Agricultural Bank of China and the People’s Construction Bank of China. On January 1, 1980, the Industrial and Commercial Bank of China was established. In 1983, The State Council decided to have the People’s Bank of China solely exercise the functions of a central bank. In 1984, the Industrial and Commercial Bank of China took over the commercial business from the People’s Bank of China. Since then, the People’s Bank of China has become the central bank of China. As a result of the banking reform, four specialized banks have emerged: the Agricultural Bank of China, the Bank of China, the Industrial and Commercial Bank of China, and the People’s Construction Bank of China.

These specialized banks have played significant roles in developing security devices in China. By the end of 1993, these banks accounted for eighty percent of the total assets of the banking sector in China. Encouraged to act more like commercial enterprises, these specialized banks are, at least in theory, responsible for raising their own funds and paying interest to depositors. Enterprises are no longer given an automatic right to credit and banks are to allocate funds on the basis of enterprise profitability. To make loans more efficient, banks have started to adopt security devices. As secured transactions serve efficient purposes, the adoption of these security devices will accelerate the transition to a market-based economy in China.

People’s Congress (August 24, 1994) [hereinafter Zhou Zhengqing Address].
22 Wu Jingling, China’s Economic and Financial Reform, in FINANCIAL REFORM IN CHINA, supra note 5, at 85.
23 Wu Xiaoling, supra note 5, at 113.
24 The People’s Construction Bank of China, originally established in 1954, was absorbed by the Ministry of Finance in 1958. Established in 1955, the Agricultural Bank of China was dissolved in 1957 and its business was taken over by the People’s Bank of China. These two banks re-emerged in the 1960s and continued only for a very short period. See ZHONGGUO JINRONG FALU SHIWU QUANSHU [HANDBOOK OF FINANCIAL LAW PRACTICE IN CHINA] 26-27 (Sun Zhiyuan ed., 1994).
25 Id. at 25.
27 Id.
28 See Eu, supra note 20.
29 See Zhou Zhengqing Address, supra note 20.
30 See Eu, supra note 2, at 489.
31 See George Triantis, Secured Debt under Conditions of Imperfect Information, 21 J. LEGAL STUD.
The central focus of this Article is on security devices. Section II discusses the various security devices used in China, including the deposit, the lien, the dian, the mortgage, the pledge, and the guarantee. The strengths and weaknesses of the legal provisions governing these security devices are also discussed. The provisions governing the use of security devices between foreign parties and domestic institutions are subject to special restrictions owing to foreign exchange controls. As such, a separate discussion concerning these provisions is provided in Section III.

II. TYPES OF SECURITY DEVICES

A. The Deposit

Parties to a contract may agree that one party (the debtor) should provide the other party (the creditor) with a deposit for an obligation. After the party providing the deposit has fulfilled the obligation, the deposit is set off against the contract price or is simply recovered. If a debtor fails to perform the obligation, the debtor does not have the right to demand the return of the deposit. If the creditor fails to perform his obligation, then the creditor must pay the debtor twice the amount of the deposit. The Security Law allows the parties the freedom to determine the amount of deposit, up to a ceiling of twenty percent of the value of the contractual obligation. As a deposit can only account for a small portion of a contractual obligation, it really cannot be considered adequate security for the obligation. For this reason, some regulations and bank rules deliberately exclude the use of a deposit as a security device.

See infra note 331 and accompanying text.
Id.
Id.
Id.
Id. art. 91.
B. The Lien

The lien is a creature of law. Normally, when a debtor fails to fulfill his obligation arising in a bailment contract, transport contract, or processing contract, the creditor has the right to a lien. If the debtor fails to fulfill the obligation specified in the contract, the creditor has the right to retain such property. The creditor can also keep the property after a valuation appraisal or enjoy priority in receiving payment from the proceeds of an auction or sale of the property. When the creditor has kept the property after an appraisal, auction, or sale, any amount that exceeds the obligation goes to the debtor; in return, the debtor must pay any shortfall.

The existence of a lien is subject to two conditions under Chinese law. First, a lien is extinguished when the creditor's right has been extinguished. Second, a lien is extinguished when the debtor provides alternative security, if such security is accepted by the creditor.

The function of the lien as a security device is of limited importance. Possession of the debtor's property is a precondition for the exercise of a lien. However, in most financial and trade credit transactions, the creditors are not able to possess any property of the debtors without using the device of pledge. Therefore, some regulations exclude the use of lien as a security device.

C. The Dian

The dian creates a contractual relation between two parties, whereby, a debtor (“dian-provider”) transfers possession of real property to the creditor (“dian-right-holder”) for the creditor’s use. The transfer of possession is for a specified period of time and for a price. The dian-provider retains the right to regain possession by paying back the original price at the end of that period. Although the dian has decreased in popularity since 1950, recent
economic developments in the PRC indicate that the use of dians may increase in the future.

1. **Characteristics of the Dian**

The dian has four main characteristics. First, the transfer of possession of the property is for a specified time. Second, the dian-right-holder may possess, utilize, and make a profit from the property. Third, the dian-provider receives consideration for the transfer of possession of the property. Fourth, the dian-provider retains the right to regain possession of the property.

The first two characteristics of a dian relate to the rights the dian-right-holder receives from the transaction. The first characteristic is that a dian-right-holder has the right to use the dian-provider’s property for a specified period. The second main characteristic is that dian-right-holders have the right to possess and use the property and make profits from the property. Dian-right-holders may use and enjoy the property either for personal or business uses. In addition, a dian-right-holder may lease the property for profit. A dian-right-holder can also create another dian on the same property for a concurrent period if, for example, the dian-right-holder finds that the property is not needed during the dian period and leasing is too troublesome. The dian-right-holder may also transfer his or her rights created by the original dian. In this case, the first dian-provider pays the original dian price at the end of the dian period to repossess the property, irrespective of the transfer price between the first dian-right-holder and the new dian-right-holder.

The third characteristic is that the dian-right-holder must pay a price for the possession and utilization of the property. According to customary practice, the price paid by the dian-right-holder is normally higher than the total rental price for the same period, but lower than the

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50. See Civil Law in China 255-57 (Zhang Peilin & Zhang Youliang eds., 1994) [hereinafter Civil Law in China].
51. Id.
52. Id.
53. Id. at 256.
54. Id.
55. See id. at 255-57.
56. Id. at 255-256.
57. Id.
58. Id.
59. Theories and Practice, supra note 47, at 130.
60. Id. at 129.
61. See Civil Law in China, supra note 50.
selling price of the property. If the dian is not paid for in cash, another alternative is payment in kind. During the dian period, the dian-right-holder must use the property with proper care. A dian-right-holder is liable to the dian-provider if damage to the property is caused by negligence or intention. When the property is damaged or lost due to force majeure, the dian-right-holder bears the risk to the extent of the dian price paid. Any additional risk is borne by the dian-provider.

The fourth main characteristic is that the dian-provider retains the right to repossess the property at the end of the dian period specified in the agreement. The dian-provider may repossess the property by paying back the price received from the dian-right-holder. However, the dian-provider loses the substantive right to repossess the property if the dian-provider, due to his or her own fault, fails to repossess the property ten years after the specified expiration of the dian period or thirty years after the creation of the dian if no specific dian period is fixed in the agreement.

The dian allows the dian-right-holder the opportunity to utilize a property if he or she can make better use of the property than the dian-provider. In this sense, it is efficient. Meanwhile, the dian-provider is able to take advantage of the money or other compensation to make other investments. No formal debtor-creditor relations are created since the dian-provider does not have to repossess the property. However, the dian-provider is disadvantaged because the dian price the dian-provider received is lower than the selling price of the property at the time of the creation of the dian. Therefore, from the dian-provider’s standpoint, the creation of a dian may be

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62 Id.
63 Id.
64 Id. at 132.
65 Id.
66 Force majeure is an event that is beyond the control of the contractual parties, such as an earthquake or tornado.
67 THEORIES AND PRACTICE, supra note 47, at 133.
68 Id. at 132.
69 CIVIL LAW IN CHINA, supra note 50, at 256. Both in theory and practice, there are two periods. The first period is the dian period that is specified in the agreement. The second period refers to the period after the expiration of the dian period, within which the dian provider has the substantive right to regain the possession of the property by paying back the dian price.
considered a secured transaction. The dian gives the dian-provider the opportunity to borrow money secured by transferring the possession, but not ownership, of his or her real property.

The dian offers owners who wish to make the best use of their properties an alternative to a mortgage. In contrast with a mortgage, a dian-provider does not have to pay back the dian price on an installment basis. Even if the dian-provider does not have the resources to pay back the dian price at the end of the period, he or she has another ten years to accumulate the money in order to repossess the property. For mortgages, a mortgagee may foreclose the mortgage by selling or auctioning the real property if and when a mortgagor defaults. The disadvantage of the dian is that the dian-provider has to transfer the possession of his or her property to the dian-right-holder.

2. Use of the Dian

Before the founding of the PRC in 1949, the dian was a prevalent method of transferring both land and houses. During this time, the dian was very popular for two reasons. First, in rural economies prior to 1949, most families were productive units and land was vital for the creation of wealth. Land was also important for the basic survival of the family. Second, successors had an obligation to maintain and increase their inherited properties in traditional China. It was considered a violation of filial piety to sell these inherited properties.

After the founding of the PRC, dians could no longer be used as a method to transfer possession of land. Since 1949, land has been nationalized and collectivized. Consequently, the ability to subject land to a dian in cities and villages no longer exists. Although land could not be transferred by dians,

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71 See discussion infra Part II.D.
72 Views.
73 Security Law art. 33.
74 THEORIES AND PRACTICE, supra note 47, at 119.
75 Id.
76 Id.
77 Id.
78 Id.
79 Id.
80 Article 10 of the PRC Constitution stipulates that land in cities is owned by the State. Land in the rural and suburban areas is owned by collectives, except for those portions that belong to the State in accordance with the law; house sites and privately farmed plots of cropland and hilly land are also owned by collectives. ZHONGHUA RENMIN GONGHEGUO XIANFA [THE CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA] art. 10, translated in [1997] China L. Foreign Bus. (CCH Austl. Ltd.) §4-500 (Dec. 4. 1982) [hereinafter PRC CONSTITUTION].
it remained quite common in the 1950s and 1960s to create dians by transferring possession of houses.\(^1\)

Since the 1970s, the creation of dians has been relatively rare.\(^2\) One reason for the decrease in dians is that since the 1960s, houses in cities and towns have been mainly provided by various enterprises and organizations. Additionally, in rural areas, living standards were low in the 1970s and early 1980s, making it difficult for farmers to transfer the possession of their properties to others.\(^3\)

Despite the decrease in the use of dians through the 1970s, in the 1980s the Supreme People’s Court recognized dian rights and obligations. Although the current statutory law does not mention whether it is still possible to use the dian device, the Supreme People’s Court issued the Views on Several Issues Concerning the Implementation of Civil Policies and Law in 1984 (“Views”) which recognized dian rights.\(^4\) Article 58(1) of the Views provides that dian rights and obligations concerning houses should be recognized within legal and policy limits.\(^5\) Four years later, the Supreme People’s Court issued the Opinions on Certain Issues Concerning the Implementation of the General Principles of the Civil Law (“Opinions”).\(^6\) The Opinions contain a provision which says that during the period when the possession of a house is with the dian-right-holder, it should be permissible for the parties to amend their agreement to extend the dian period and to increase or decrease the price.\(^7\) These provisions make it possible for people to create and use dians.

Current conditions in the PRC indicate that the use of dians may increase in the future. Under the economic reform program, living standards have increased in both cities and rural areas.\(^8\) Additionally, private ownership of houses has increased very quickly.\(^9\) Ownership particularly increased when the Chinese government decided in 1998 to stop the tradition of supplying welfare houses to employees through various enterprises and

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\(^1\) See CIVIL LAW IN CHINA, supra note 50, at 255.

\(^2\) See THEORIES AND PRACTICE, supra note 47, at 119.

\(^3\) In 1978, the annual disposable income per person in the rural areas was around 134 yuan. RENMIN RIBAO [PEOPLE’S DAILY] (Overseas Edition), Oct. 13, 1998, at 1.

\(^4\) Views.

\(^5\) Id. Currently, no law or policy prohibits the creation of a dian over houses.


\(^7\) Id. art. 120.

\(^8\) For example, from 1980 to 1997, per capita income in urban China increased from 1261 yuan to 4656 yuan. See ZHONGGUO GAIGE BAO [CHINA REFORM DAILY], Oct. 12, 1998.

\(^9\) For example, in the first half of 1998, private individuals purchased over 90% of the houses and flats in certain districts in Hangzhou. XINHUA NEWS AGENCY, Sept. 10, 1998.
organizations. In the future, houses in China will be an ordinary commodity. As private ownership of houses increases, along with the increase in mobility of people, the dian will be more frequently used.

D. Mortgages

The term "mortgage" refers to a transaction whereby a debtor or a third party ("mortgagor") uses certain property ("mortgaged property") as security for an obligation without the transfer of the possession of such property. If the debtor fails to fulfill his or her obligation, the creditor ("mortgagee") has priority over the property after a valuation appraisal or may receive proceeds from the auction or sale of the property.

Before the Security Law became effective in October 1995, the statutory law on mortgages was very brief and vague. In the General Principles of Civil Law ("Civil Law"), there is only one definition provision for mortgages. To make the mortgage system operational, the Supreme People's Court fleshed out the law in this area in its Opinions. Given the relatively detailed provisions in the Security Law, many provisions in the Opinions are superseded. A few others are no longer valid as they contradict the Security Law.
1. Properties Which Can or Cannot be Mortgaged

Laws and regulations in China specify properties that can be mortgaged. According to the Security Law, properties which can be mortgaged include: i) premises and other attachments to land owned by the mortgagor; ii) machinery, communication and transportation equipment, and other properties owned by the mortgagor; iii) state-owned land-use rights, premises and other attachments to land which the mortgagor has the right to dispose of according to law; iv) state-owned machinery, communication and transportation equipment, and other properties which the mortgagor has the right to dispose of according to law; v) land-use rights over barren hills, gullies, mounds, beaches, etc., which have been lawfully contracted for by the mortgagor, if the mortgagor also obtains the consent of the party that contracted out these rights to the mortgagor; and vi) other property that may be mortgaged according to law. Whether properties not mentioned in the Security Law can be mortgaged may be specified by other laws. For instance, if, in the future, the Constitution allows for the private ownership of land, the mortgage of land would then be possible.

The ability to mortgage state-owned land-use rights is a significant step in the history of the PRC. Article 2 of the 1988 Amendment to the Constitution permits the transfer of a land-use right. This change is the fruit of the ongoing economic reform program. Before 1988, no organization or individual could appropriate, buy, sell, lease, or otherwise engage in the transfer of land.

There are three ways to acquire a land-use right of state-owned land. First, land-use rights may be obtained through allocation. Under this method, the user generally does not pay a land-use right fee. Second, the government may sell land-use rights by auction, tender, or mutual negotiation and agreement. Land-use rights acquired through a sale can be

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99 "Attachments to land" refers to property such as trees, swimming pools, sculptures, and chimneys.

100 "Other properties" include products, inventories, and animals.

101 Security Law art. 34(5) encourages cultivation of barren hills, gullies, mounds, and beaches.

102 Security Law art. 34(6) is a catchall provision that permits future development.

103 Security Law art. 34(5).

104 PRC CONSTITUTION art. 2.

105 Id. art. 10.


107 Id. art. 7.

108 Id. art. 12.
mortgaged. Third, land-use rights may be obtained through a transfer. Under this method, the new right-holder pays the land-use right fee to the original holder who has already acquired the land-use right from the state. Since land-use rights acquired by sale may be mortgaged, land-use rights obtained by transfer can also be mortgaged. However, a new user of the land-use right must seek approval from the local government and pay the land-use right fee to the government if the land-use right was originally received through governmental allocation by the original user. Once approval is obtained and the appropriate fee is paid, the new user of the land-use right may also mortgage the land-use right.

Whether state-owned machinery, communication and transportation equipment, and other properties can be mortgaged depends upon whether the user has the right to dispose of the property. The property of a wholly state-owned enterprise is owned by all the people, and is operated and managed by the enterprise under the authorization of the state in line with the principles of separation of ownership and managerial authority. The enterprise enjoys the rights to possess, utilize, and dispose of the property that the state has authorized it to operate and manage. Thus, state-owned enterprises have the right to mortgage machinery, transportation equipment, and other property in their enterprises.

Statutes and regulations prohibit owners from mortgaging certain types of property. For example, the Security Law prohibits four categories of properties from being mortgaged. First, land may not be mortgaged. This is because the Constitution prohibits the private ownership of land. Second, educational, medical, public health, and other public welfare facilities cannot be mortgaged. The rationale is that the realization of the mortgagee’s right by selling the mortgaged property will disrupt the normal function of these institutions. The disruption, in turn, will cause harm to the public. Third, certain properties with unclear or disputed ownership or use rights may not be mortgaged. Fourth, properties that are sealed up, seized, or subject to

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110 Id. art. 47.
111 Id. arts. 36-39.
112 Id. art. 39.
114 Id.
115 Security Law art. 37.
116 PRC CONSTITUTION art. 10.
117 Security Law art. 37(3).
supervision and control cannot be mortgaged. In addition to the Security Law, other laws may also prohibit the use of certain property as mortgage security. For instance, as originally enacted, the Mineral Resources Law did not allow the mortgage of the right to exploit mineral resources.

The Security Law states that a mortgagor may use all legally permissible properties to secure a loan. For instance, a company may mortgage attached property such as buildings and movable property including machinery, equipment, and inventory. This provision in the law gives the impression that floating charges are permissible in China. A careful reading of Article 34 suggests the opposite. The property mentioned in this provision must be certain at the time the mortgage is created. Other provisions also support this position. For instance, buildings newly created on a piece of land, after a mortgage contract for the urban real property has already been signed, may not be subject to a mortgage.

2. Formality and Content

To adopt a mortgage, a mortgagor and a mortgagee must enter into a written mortgage contract. A mortgage contract must have the following items: i) the type and amount of the principal obligation secured; ii) the time of performance of the obligation by the debtor; iii) the name, quantity, quality, state, location, and ownership or use right of the mortgaged property; iv) the scope of the security covered by the mortgage; and v) other matters which the parties consider necessary to agree upon. A mortgage contract that does not include all of these items may be amended. Unfortunately, the drafters fail to understand that any omission of the obligation secured or of the nature of the mortgaged property may cause injustice to an innocent third party. As

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118 Security Law art. 37(4), (5).
119 Security Law art. 37(6).
121 Security Law art. 34.
122 Id.
123 In a floating charge, the assets, covered by the charge, of the charger do not have to be certain at the time of creation of the charge.
125 Security Law art. 55.
126 Security Law art. 38.
127 Security Law art. 39.
128 Id.
most mortgage contracts are required to be registered, registration provides notice to the public about the nature of a mortgage.\footnote{See Security Law art. 41. Articles 44 and 45 of the Security Law require the registration of the principal contract and the mortgage contract for most mortgaged property. Documents of certificates of ownership or use rights of the mortgaged property must also be supplied to the registration authority. The public is given the right to read or copy these registered materials. For a discussion of the properties that need to be registered, see infra note 135 and accompanying text.} An omission in the mortgage contract may mislead third parties who rely on the registration.

Under Chinese law, the Standing Committee of the National People’s Congress\footnote{PRC Constitution art. 67(4).} or the Supreme People’s Court may issue legally binding interpretations of vague commercial laws.\footnote{Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Guanyu Jiaqiang Falu Jieshi Gongzuo de Jueding [Resolution of the Standing Committee of the National People’s Congress on Providing an Improved Interpretation of the Law] art. 2 (1981), available in LEXIS, Asiapc Library, Chinalaw File. The Resolution provides in Article 2 that interpreting questions involving the specific application of laws and decrees in court proceedings shall be provided by the Supreme People’s Court.} As the Standing Committee focuses its attention on drafting and amending laws, the Supreme People’s Court provides most of the interpretations of laws. In the context of an omission in a mortgage contract, the Supreme People’s Court may provide the following plausible interpretation that a mortgage agreement is not unenforceable against a third party by reason of only a defect, irregularity, omission or error therein, or in the execution thereof, unless the third party is misled by the defect, irregularity, omission or error. With respect to the contracting parties, an omission in a mortgage contract can be corrected so long as the parties are able to reach an agreement.

The Security Law is very restrictive with respect to precontract negotiation. According to the Security Law, a mortgagee and a mortgagor may not agree that the ownership of mortgaged property shall be transferred to the creditor if the mortgagor fails to fulfill his obligations at the expiration of the term for performance of an obligation.\footnote{Security Law art. 42.} Unfortunately, this provision is too restrictive. There is no reason why the freedom of the parties to transact should be restricted by unconcerned parties. If the policy is to protect the mortgagor against exploitation, then the policy should be pursued through a rule of unconscionability in the general law of contracts.\footnote{A rule of unconscionability should enable the court to correct misconduct that occurs in the bargaining process because one party abuses his or her information or bargaining advantage.} Although unconscionability is not found in Chinese contract law, the principles of honesty and good faith achieve this purpose.\footnote{The principles of honesty and good faith are stated in many laws. See, e.g., Civil Law art. 4; Security Law art. 3.} The current position of the law is only justifiable if potentially unconscionable behavior incurs higher costs
relative to the benefits offered if the ban were lifted. The burden should be on those who insist on the ban to show that mortgagors are not able to protect themselves, even with the assistance of the court under the rule of honesty and good faith. This issue, however, must ultimately be resolved on empirical grounds. Without such empirical evidence, the current law cannot be justified given the great benefits available if the ban were lifted. Prohibiting the freedom of the parties to contract inhibits many welfare and liberty enhancing transactions.

3. Registration and Priority

For most mortgaged properties, registration is required. Instead of having one or two registration authorities, numerous governmental agencies exist for the purpose of registration in China. The authorities for the registration of mortgaged properties are divided into five categories. First, the land administration authority verifies and issues certificates of land-use rights. This administration is responsible for the registration of mortgages over land-use rights on land with no attachments. Second, an authority designated by the local People’s Government, at or above the county level, is responsible for the registration of mortgaged urban real property or factory buildings in towns or villages. Third, the forestry administration authority, at or above the county level, is in charge of registering mortgaged woods or trees. Fourth, the registry of transportation has jurisdiction to register mortgaged aircraft, vessels or vehicles. Fifth, the administration of industry and commerce is responsible for the registration of mortgaged equipment or other moveables of enterprises within its jurisdiction. The registration of the aforementioned property is compulsory. A mortgage contract for such property becomes effective on the date of registration.

Where the parties mortgage property other than the aforementioned properties, registration is on a voluntary basis. Mortgaged properties that do not require registration are economically less significant. They include, among others, home appliances, furniture, and animals. The rationale is that it may

135 Security Law art. 41.
136 These registration agencies benefit by collecting registration fees that may be very substantial. Other benefits include employment opportunities and visibility of these agencies.
138 Security Law art. 42.
139 See Security Law art. 41.
140 Id.
141 Security Law art. 43.
not be convenient for people to register those types of property, particularly for
people living in areas far away from the registration authorities. When
registration is not required, the validity of the mortgage contract between the
contractual parties is based on the signing of the contract. The mortgagor’s
right against any third party, however, may depend on registration. This type
of mortgage contract becomes valid as soon as the contract is signed. The
authority that is responsible for registering such mortgaged property, which is
not subject to compulsory registration, is the notarial authority of the place
where the mortgagor is located.

Under current law, registration of mortgaged property subject to
compulsory registration requirements affects both the validity of the mortgage
contract between the contractual parties and any competing right of the
mortgagor against third parties, on the other hand, registration of mortgaged
property which is not subject to compulsory registration only affects the right
of the mortgagor against third parties. The reason why the validity of
mortgage contracts for certain property depends upon registration is not clear.
Under the rigid economic planning system, most economic contracts must
comply with the procedures of approval or registration. Approval or
registration is purely for the purpose of control and planning. The formation
of an economic contract only occurs upon the completion of these
procedures. Applying this contract law position to the law on secured
transactions creates serious problems. The rationale of requiring registration
of mortgaged property is to give notice to third parties who may accept the
same collateral when extending credit. If the creditor knows that the same
collateral has already been subject to a mortgage, the creditor may decide to
accept alternative collateral or simply not to provide credit. If the validity of
some contracts still depends upon approval or registration, then the validity
of these contracts should be regulated by other laws or regulations for the
purpose of controlling other aspects of business activities. For instance, the
Procedures on the Administration of the Provision of Security to Foreign
Entities by Domestic Institutions Inside China require the registration of
security devices when such devices are adopted between foreign entities and

143 Id.
144 Security Law art. 43.
145 Id.
146 See Security Law arts. 41, 54.
147 An example can be found in Article 7 of Zhonghua Renmin Gongheguo Shewai Jingji Hetongfa
148 See Chen Tung-pi, supra note 21, at 110, 111.
149 Article 32 of the proposed uniform Contract Law states that non-compliance with approval or
registration requirements may affect the validity of these contracts.
domestic institutions with the State Administration of Foreign Exchange;\footnote{Supra note 38 and accompanying text.} this requirement is in addition to the registration requirement under the Security Law. Registration under the Security Law should not affect the validity of the mortgage contract itself, but rather, the right of the mortgagee against third parties who rely upon the notice system. Reform of the law along this line will substantially improve the law of mortgages in China.

Whether a mortgagee has priority over the same property against another mortgagee depends either on the date of registration or the date of signing the mortgage contract. The Security Law provides that mortgages only become effective when registered in the case of compulsory registration or when signed in the case of voluntary registration.\footnote{Security Law arts. 41, 43.} Because of the two parallel schemes, priority\footnote{Priority determines which secured creditor should be satisfied first when the debtor or mortgagor's same asset or class of assets is subject to the claims of several secured creditors.} contests are resolved on the basis of registration or creation, depending on statutory requirements. As between registered mortgages, the mortgage registered first will have priority.\footnote{See Security Law art. 54(1).} If a case arises between two registered mortgages with the same registration date, payments are made to each creditor according to the proportion of the obligations.\footnote{Id.} As between unregistered mortgages, the mortgagee with the earliest signed contract will have priority.\footnote{See Security Law art. 54(2).} If two unregistered mortgages are signed on the same date, then payment is made according to the proportion of the obligations.\footnote{Id.} Between registered and unregistered mortgages, priority shall go to the mortgagee who has registered the mortgaged property even if the unregistered mortgage is signed first.\footnote{Id.}

When a conflict occurs between a secured creditor or mortgagee and a general creditor, the priority issue is resolved by Article 89(2) of the Civil Law. Article 89(2) provides a basic rule: "If the debtor defaults, the secured creditor has the right, in accordance with legal provisions, to keep the collateral to offset the debt or have priority in satisfying his claim out of the proceeds from the sale of the collateral."\footnote{Civil Law art. 89(2).} This provision mandates that the holder of a security interest generally has priority over an unsecured creditor.
4. Rights and Obligations of Mortgagors and Mortgagees

The Security Law contains a default rule concerning the scope of obligations secured through a mortgage. Article 46 covers the principal obligation, interest, liquidated damages, compensatory damages, and expenses for the realization of mortgage rights. As the phrase "expenses for the realization of mortgage rights" is subject to differing interpretations, the parties should use the permissive language of the Article to specify these expenses. Because this provision is a default rule, the parties can either enlarge or reduce the scope of the secured obligations.

Under the Security Law, a mortgage does not affect any existing lease. When a leased property is mortgaged, the lessee is entitled to notice. This position can be justified because the mortgagee has the capacity to examine and ascertain the status of the property. If the property is burdened by a lease, the mortgagee may choose not to accept the mortgaged property or to extend the credit.

As a mortgagor remains in possession of the property during the term of a mortgage, behavior that may affect the value of the mortgaged property is the subject of much concern. To address these concerns, several provisions were adopted to protect the interest of the mortgagee. If a mortgagor transfers the mortgaged property during the term of the mortgage, he must notify the mortgagee and inform the transferee of the mortgage of the property. If the above requirement is not met, the transfer is void.

The law permits the transfer of ownership of mortgaged property; therefore, the interest of the mortgagee may be affected. To deal with that issue, Article 49 of the Security Law provides that if proceeds from a transfer of a mortgaged property are obviously less than the value of such mortgaged property, the mortgagee may require the mortgagor to provide a corresponding security. Where the mortgagor fails to provide such a security, the mortgaged property should not be transferred. Two problems arise from Article 49. First, it is unclear whether the reduction in value of the property caused by market fluctuations is also covered by this provision. If so, the

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159 See Security Law art. 46.
160 Id.
161 See id.
162 Id. art. 48.
163 Id.
164 See id. arts. 49, 51.
165 Id. art. 49.
166 Id.
167 Id. art. 49.
168 Id.
mortgagee is virtually insured, despite its bad judgment in accepting the collateral. Second, according to Article 49, proceeds obtained by the mortgagor from the assignment of the mortgaged property shall be paid to the mortgagee as advance fulfillment of the obligation secured or be deposited with a third party agreed upon by the mortgagee. Any portion in excess of the amount of the obligation goes to the mortgagor and the debtor must pay any shortfall. Considering that creditor's rights are not adequately protected in China, the mortgagor's control of the proceeds may breed fraud.

The Security Law gives the mortgagee the right to stop any misconduct that may reduce the value of the mortgaged property. If the mortgagor's misconduct causes the reduction in value, the mortgagee has the right to require the mortgagor to either restore the value of the property or provide other security corresponding to the diminished value. However, the mortgagee is not entitled to protection if the reduction in value is not due to the fault of the mortgagor. If a third party damages the mortgaged property, the mortgagee may only require the mortgagor to provide security to the extent of the compensation received by the mortgagor. The portion of the mortgaged property that has not diminished in value must still serve as security for the obligation.

Under Chinese law, a mortgage contract is a subordinate contract to the contract creating the debt obligation. Thus, the mortgage and the principal secured obligation co-exist. Consequently, when the principal obligation is extinguished, so is the mortgage. Similarly, mortgage rights may not be assigned separately from the principal obligation or be used to secure another obligation.

A discussion of the law of mortgages is incomplete without examining the issue of realization. If a mortgagee is unable to receive full payment at the expiration of the term for performance of the principal obligation, he or she may agree with the mortgagor to keep the mortgaged property after a valuation appraisal of the property or to obtain the proceeds from the auction or sale of
the property. Unlike the law governing pledges, a mortgagee does not have the right to unilaterally dispose of the mortgaged property if an agreement concerning the disposition of the property is not possible. Failing agreement, the mortgagee has to bring a lawsuit. If the mortgagee keeps either the mortgaged property after appraisal, or the proceeds from an auction or sale, any portion that exceeds the amount of the principal obligation goes to the mortgagor; in turn, the debtor must pay any shortfall.

If a People’s Court seizes a mortgaged property due to the debtor’s failure to perform his or her obligation at the expiration of the term for such performance, then the mortgagee, from the date of seizure, is entitled to both natural fruits separated from the mortgaged property and statutory fruits produced by the mortgaged property. In order to obtain statutory fruits, the mortgagee needs to notify the persons who are obliged to pay the statutory fruits. The total recovery is reduced by any expenses incurred in obtaining the fruits. Sometimes, a third party provides a mortgage for a debtor. In that case, the third party has recourse against the debtor after the mortgagee has realized his or her mortgage rights. If a mortgaged property is lost due to the fault of others, the compensation received from others serves as mortgaged property.

Mention should also be made about the flexible “maximum amount mortgage” for a series of credit transactions. According to the “maximum amount mortgage,” a mortgagor and a mortgagee may agree to use mortgaged property as security for a series of obligations over a certain period of time up to a maximum amount. This method may be used for financial credit or trade credit transactions.

Mortgages play a significant role in Chinese society. Following the adoption of the Security Law, the mortgage is more widely used in China. The Bank of China, the People’s Construction Bank of China, the Bank of Industry and Commerce of China, and the Agricultural Bank of China all have adopted

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180 See id. art. 53.
181 See discussion infra Part II E.
182 Security Law art. 53.
183 See id.
184 Id. art. 53.
185 Id. art. 47. An example of natural fruit is the apples on an apple tree and an example of statutory fruit is the interest derived from the mortgaged property.
186 Id.
187 Id.
188 Id. art. 57.
189 Id. art. 58.
190 Id. art. 59.
191 See id.
their own rules for dealing with security transactions, including mortgages. The rules designed by these banks include the use of the device of mortgages. These rules sometimes spell out the position of the bank when laws and regulations permit free negotiation. Given the poor enforcement of insolvency judgements, the laws governing mortgages provide some comfort to creditors. There is no doubt that laws governing mortgages will play an increasing role in China’s transition from a planned to a market economy.

E. Pledges

For the first time in the history of the PRC, the Security Law of China provides a unified position and relatively detailed provisions on pledges at the national level. There are two types of pledges: the pledge of movable properties, and the pledge of rights (“documentary intangibles”). This subsection is intended to examine the law governing pledges and possible interpretations of the law. Both the pledge of movables and the pledge of rights will be discussed.

The pledge of movables refers to the delivery of movables by a debtor or a third party (“Pledgor”) to a creditor (“Pledgee”) for the purpose of securing an obligation. The movable property transferred is defined as the pledged property. When the pledgor fails to perform his or her obligation, the pledgee is entitled to the title of the collateral after a valuation appraisal (zhe jia), or to priority in receiving payment from the proceeds of an auction or sale of the pledged property in accordance with the Security Law.

Although the Security Law does not define the phrase “pledge of rights,” the Security Law does list the rights capable of being pledged in the following four categories: i) bills of exchange, cheques, promissory notes,

192 These rules appear in different collections of banking laws, regulations, and rules. See, e.g., ZHONGGUO QIYE FALU SHIWU SHOUCE [HANDBOOK OF ENTERPRISE LEGAL PRACTICE IN CHINA] (1997) [hereinafter LEGAL PRACTICE IN CHINA].

193 Such judgments are difficult to enforce due to the lack of an adequate social welfare and unemployment program. The Chinese Government is quite concerned with the problem of unemployment as this may affect social stability. Currently, there are around 5.8 million graduates from high schools and universities who want to enter into the job market. Further, there are about 18 million who have been laid off from enterprises during the last several years. Interview with Mr Chang Xiuze, Research Fellow with the State Development and Planning Commission (Oct. 1998).

194 Movables are defined as tangible property other than immovables. Immovables are defined as tangible property that will substantially depreciate in value if moved from their original location. For instance, a table is a movable while a house is an immovable.

195 Security Law art. 63.

196 Id.

197 Id.

198 Id.

199 Id.
bonds, certificates of deposits, warehouse receipts, and bills of lading; ii) shares and share certificates that are transferable according to law; iii) legally transferable property rights contained in trademarks, patent rights and copyrights; and iv) other legally pledgeable rights. 200

As a security device, the pledge serves an efficient purpose by increasing the amount of credit available to deserving debtors and reducing the conflict between creditors and debtors. 201 Unfortunately, because the pledgee must possess the pledged property, the pledge’s usefulness is seriously restricted. In most cases, financing modern business transactions requires that the borrower remain in possession of the goods, for processing, resale, or use. 202 For personal loans, however, the pledge is still a useful tool when the consumer may deliver gold, jewelry, or other non-productive items to the pledgee. Between commercial entities, this type of pledge is less useful.

The lack of flexibility of the pledge of movable property resulted in the pledge of documentary intangibles (rights). 203 The invention of the documentary pledge has made the pledge a somewhat more useful financing device under circumstances such as when goods are in transit; in industries where goods, such as wines and preserved foods, can remain in storage a long time; or where an expected quick turnover has not materialized. 204 Compared to movable property, documentary intangibles are more capable of being transferred. 205 Thus, trade or financial creditors are more likely to adopt a pledge of rights.

1. The Pledge of Movables

The law governing pledges mandates that the pledgor and pledgee enter into a written contract. 206 However, the written contract by itself does not make the pledge contract effective. The delivery of the movable property to the pledgee is also required. 207 Only when a transfer of the pledged property is executed will the pledge contract become effective. 208 Thus, if there is no transfer of possession of the movable property, the pledge is void between the

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200 Id. art. 75.
201 A secured debt may serve the purpose of reducing the ex ante adverse selection problem and the ex post moral hazard problem. In that sense, it is efficient. For more information of the efficiency role of secured debts, see Triantis, supra, note 31, at 234-38, 249-51.
203 Id. at 522.
204 Id.
205 Id.
206 Security Law art. 64.
207 Id.
208 Id.
pledgor and pledgee or as against a third party. Requiring the transfer of possession to validate a pledge contract can be justified. Without this requirement, a third party may be misled into taking already pledged collateral for a credit transaction. However, the failure to transfer possession of the pledged property should not invalidate the pledge contract. Instead, the non-transfer should defeat the pledgee’s priority against a third party.

The Security Law divides the provisions of the pledge contract into mandatory provisions and voluntary provisions. Mandatory provisions include: i) the type and amount of the principal obligation secured; ii) the term for performance of the obligation by the debtor; iii) the name, quantity, quality, and state of the pledged property; iv) the scope of security covered by the pledge; and v) the time of transferring the pledged property. The parties may freely insert any other provisions into the pledge contract.

Caution should be taken with Article 65 of the Security Law, which stipulates that pledge contracts that do not contain all of the contents specified in the proceeding provision may be amended. This provision raises the issue of whether the omission of any of the mandatory provisions can be amended. If so, when should the defects be rectified? Such questions are concerned with whether drafters of the statute would prefer to emphasize form or substance. These questions of statutory interpretation need to be answered by the Supreme People’s Court. Since the Court has not yet spoken, these questions are still unanswered. Because a sophisticated legal culture has yet to be developed in China, too much emphasis on formalities may cause injustice. It is still the policy for Chinese lawmakers that when things can be expressed in plain words and simple sentences, no complicated words or sentences should be used. Given these facts, a plausible interpretation is that a security agreement is not unenforceable against a third party by reason of a defect, irregularity, omission or error therein, or in the execution thereof, unless the third party is misled by the defect, irregularity, omission or error. A broader reading of the provision would emphasize form over substance. Of course, to serve the purpose of notice to the public, certain formalities are essential. However, the successful maintenance of a formalized system of law depends on professionalization. If amateurs replace the rules by reading the statutes broadly, emphasizing form over substance, the system will break down.

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209 Id. art. 65.
210 Id.
211 Id.
212 Id.
213 Grant Gilmore, Security Law, Formalism and Article 9, 47 NEB. L. REV. 659, 670 (1968).
214 Id. at 670.
The Security Law prohibits any agreement between the pledgor and the pledgee wherein the property rights of the pledged property are transferred to the pledgor from the pledgor if the pledgor has not fulfilled his or her obligation at the expiration of the term for performance of the obligation. The purpose of the provision is to protect the pledgor. However, the focus is misplaced. There is no reason why unconcerned parties should restrict the freedom of the contracting parties. If the protection of the pledgor is the goal, the rule of unconscionability in the general law of contract is adequate. Prohibiting the freedom of the parties reduces many welfare and/or liberty enhancing transactions.

Unless otherwise agreed, the scope of security provided by a pledge covers the principal obligation, interest, liquidated damages, compensatory damages, and expenses for the custody of pledged property and realization of the pledge. As the phrase “expenses of realizing the collateral” is subject to differing interpretations, it is advised that the parties use the permissive language of the law to specify the expenses. The pledgee is entitled to the monies produced by the pledged property unless the contract contains contrary provisions. Any expenses incurred in recovering the monies reduce the total recovery.

The pledgee has a duty to keep the pledged property in proper custody. Where the pledged property is lost or damaged due to improper custody, the pledgee is civilly liable. Furthermore, the pledgor may require the pledgee to lodge the pledged property or propose that the obligation be fulfilled and ask for the return of the pledged property earlier if the pledged property may be lost or damaged due to the inability of the pledgee to keep it in proper custody.

Where there is a probability that the pledged property may be damaged or may diminish in value to an extent sufficient to jeopardize the pledgee’s rights, the pledgee may require the pledgor to provide corresponding

215 Security Law art. 66.
216 See supra note 133.
217 For a similar criticism, see supra notes 133 & 134 and accompanying text.
218 Security Law art. 67.
219 Id. art. 68.
220 Id.
221 Id. art. 69.
222 Id.
223 To lodge the property means to send the property for safe custody to a mutually agreed upon third party. The third party solves the conflict of interest problem between the contractual parties as the pledgee may abuse the possession of the property.
224 Security Law art. 69.
225 The pledgee must raise the issue that he or she may be harmed because of the reduction in value of the pledged property. If the parties disagree, however, the pledgee bears the burden to prove in a court of
security. If the pledgor refuses to do so, the pledgee may auction or sell the pledged property and agree with the pledgor to use the proceeds from the auction or sale for early fulfillment of the obligation secured, or to deposit the proceeds with a third party agreeable to the pledgor.

When a debtor performs his or her obligation at the contractually specified time of performance or fulfills his or her obligation secured by the collateral ahead of time, the pledgee must return the pledged property. This is called an extinction of the pledge by performance. If the pledgee does not receive payment at the expiration of the term for performance of the obligation, he or she has two options. First, the pledgee may agree to obtain the title to the pledged property after a valuation appraisal. Second, the pledgee may auction or sell the pledged property according to the law. After the pledged property has been kept by the pledgee, auctioned, or sold, the pledgor receives any portion of the value or proceeds that exceeds the amount of the obligation and the debtor must pay any shortfall.

The pledge and the obligation secured by the collateral must coexist. When the pledgor pays the principal obligation, the pledge is extinguished. The pledge shall also be extinguished by the loss of the collateral. However, the compensation obtained for such loss is considered a substitute for the pledged property.

The Security Law has only one provision on third party pledgors. Pursuant to that provision, after the realization of the pledged property by the pledgee, the third party pledgor has recourse against the debtor.

2. *The Pledge of Rights*

Physical transfer of documents is required to secure a pledge of rights. In the case of a pledge of bills of exchange, cheques, promissory notes, bonds,
certificates of deposit, warehouse receipts or bills of lading, the pledgee must receive the documents of right within the contractually specified time.\textsuperscript{239} The pledge contract becomes effective on the date the documents are delivered.\textsuperscript{240} The parties shall check the validity and transferability of these documents in accordance with the relevant laws, such as, the Negotiable Instrument Law,\textsuperscript{241} the Maritime Law,\textsuperscript{242} and other laws and regulations.\textsuperscript{243}

Some bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts or bills of lading may specify a date for converting the document into cash or delivery of goods.\textsuperscript{244} If the date for converting the document into cash or delivery of goods falls before the term for performance of the principal obligation, the pledgee may cash it or deliver the goods prior to the expiration of the term.\textsuperscript{245} The pledgee may agree with the pledgor to use the amount cashed or the goods delivered for early fulfillment of the secured obligation or to deposit the amount cashed or the goods delivered with a third party agreeable to the pledgor.\textsuperscript{246}

In the case of a pledge of share certificates that are transferable according to law, the pledgor and the pledgee must conclude a written contract and register the pledge with the appropriate securities registry.\textsuperscript{247} The pledge contract becomes effective on the date of registration.\textsuperscript{248} Share certificates may not be transferred after they have been pledged, unless the pledgor and pledgee agree to the contrary.\textsuperscript{249} Should the parties agree to a transfer, the proceeds obtained by the pledgor from the transfer of share certificates are used for early fulfillment of the secured obligation to the pledgee or deposited with a third party agreeable to the pledgee.\textsuperscript{250}

There are many restrictions on the transfer of shares in various laws and regulations. In the case of a pledge of share certificates in a limited liability company, the relevant provisions of the Company Law,\textsuperscript{251} for the transfer of

\textsuperscript{239} See id. art. 76.
\textsuperscript{240} Id.
\textsuperscript{241} Zhonghua Renmin Gongheguo Piaojufa [PRC Negotiable Instrument Law], \textit{translated in} 3 China L. Reference Service (Asia L. & Prac.), Ref. No. 95.05.10 (Jan. 1, 1996).
\textsuperscript{243} Article 75(4) of the Security Law provides that pledgeable rights include other rights which may be pledged according to law. The purpose of such a provision is to leave room for future development.
\textsuperscript{244} See id. art. 77.
\textsuperscript{245} Id.
\textsuperscript{246} Id.
\textsuperscript{247} Id. art. 78.
\textsuperscript{248} Id. The provisions concerning the pledge of movables apply, mutatis mutandis, to the pledge of rights. See Security Law art. 81.
\textsuperscript{249} See id. art. 78.
\textsuperscript{250} Id.
\textsuperscript{251} Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People's Republic of China],
share certificates apply. The pledge contract becomes effective on the date when the pledge of the share certificates is recorded in the register of shareholders.\textsuperscript{252} Article 35 of the Company Law makes it possible for shareholders of a limited liability company to freely transfer share certificates among themselves. However, if shareholders transfer the certificates to persons who are not shareholders, over half of the shareholders must consent.\textsuperscript{253}

In addition to the restrictions imposed by Article 35 of the Company Law, there are many other restrictions on the transfer of shares and share certificates. First, promoters of foreign invested joint stock companies are prohibited from transferring their shares within three years after incorporation.\textsuperscript{254} The original approval authorities\textsuperscript{255} must consent if their shares are to be sold three years after incorporation.\textsuperscript{256} Foreign invested enterprises, e.g., companies with B shares\textsuperscript{257} and companies with H or N shares transformed to foreign invested joint stock companies, must also obtain

\textsuperscript{252} Security Law art. 78.
\textsuperscript{253} Company Law art. 35(2); Security Law art. 78(3).
\textsuperscript{255} The original authorities include the Ministry of Foreign Trade and Economic Cooperation.
\textsuperscript{256} Provisions on the Establishment of Foreign Investment Companies art. 8.
\textsuperscript{257} Shares may be divided into A shares, B shares, H shares, and N shares according to the places the shares are listed or the investors targeted. All shares are denominated in Chinese currency. A shares are the shares listed on the Stock Exchange of Shanghai and the Stock Exchange of Shenzhen and are traded in Chinese currency among domestic Chinese citizens. B shares are also listed on these two stock exchanges but are traded in foreign currency and by foreign companies and individuals, and people from Hong Kong, Taiwan and Macao, and Chinese citizens outside of China. H shares and N shares are the shares listed on the stock exchanges of Hong Kong and New York respectively.

A shares are governed by the Gupiao Faxing yu Jiaoyi Guanli Zanxing Tiaoli [Provisional Regulation of the Administration of Issuing and Trading of Shares] (1993), \textit{reprinted in} COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 480 (Wang Huaian et al. eds., 1993) [hereinafter Regulations on Issuing and Trading Shares]. However, the name "A Share" is not used in the regulation. Instead, it is used by practitioners to distinguish B shares and H shares. B shares are governed by Guowuyuan Guanyu Gufen Youxian Gongsi Jingnei Shangshi Waizigu de Guiding [State Council, Provisions Concerning the Listing of Foreign Investment Shares Inside China by a Company Limited by Shares], \textit{reprinted in} COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 479 (Wang Huaian et al. eds., 1995) [hereinafter Provisions on Listing Foreign Investment Shares]. The Provisions on Listing Foreign Investment Shares only use the phrase "foreign investment shares." The phrase "B shares" is used by practitioners. H shares and N shares are governed by Guowuyuan Guanyu Gufen Youxian Gongsi Jingwai Muji Gufen ji Shangshi de Tebie Guiding [State Council, Companies Limited by Shares Issuing Shares and Seeking Listing Outside China, Special Regulations] (1994), \textit{reprinted in} COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 477 (Wang Huaian et al. eds., 1994). Again, the Regulation only uses the phrase "listing shares overseas." The names of H shares and N shares are used by practitioners according to the places these shares are listed such as Hong Kong and New York.
the consent of the original approval authorities.\textsuperscript{258} Similarly, shares of promoters in other joint stock companies are not legally transferable within three years after incorporation.\textsuperscript{259} In addition, the shares of directors, supervisors and the general manager of a joint stock company are not transferable during the term of their service.\textsuperscript{260} Second, the transfer of a party's contribution to the registered capital of an equity joint venture requires the consent of the other party or parties, a unanimous board resolution, and approval of the transfer by the original examination and approval authorities.\textsuperscript{261} Third, shares that are owned by the state and not listed in the Stock Exchanges of Shanghai or Shenzhen are not normally transferable unless the relevant governmental department approves the transfer.\textsuperscript{262} Fourth, A shares\textsuperscript{263} can only be sold to domestic entities or people, whereas, B shares can only be sold to foreign persons or persons from Hong Kong, Taiwan and Macao or Chinese citizens who reside outside of mainland China.\textsuperscript{264}

As for the legal transfer of the exclusive use of trademark or property rights contained in patent rights and copyrights, the pledgor and pledgee should enter into a written contract and register the pledge with the authorities for the administration of such trademark, patent, or copyright.\textsuperscript{265} After the rights specified in Article 79 of the Security Law have been pledged, the pledgor may not assign such rights or permit others to use such rights.\textsuperscript{266} However, the pledgor may do so upon agreement with the pledgee.\textsuperscript{267} The pledge contract becomes effective on the date of registration.\textsuperscript{268} The assignment fee or license fee obtained by the pledgor may be used for early fulfillment of the secured obligation to the pledgee or may be deposited with a third party agreeable to the pledgee.\textsuperscript{269} According to Article 79 of the Security Law, the parties to a pledge may not pledge the personal rights contained in patents and copyrights.\textsuperscript{270}

\textsuperscript{258} Provisions on the Establishment of Foreign Investment Companies arts. 15, 21 & 23.
\textsuperscript{259} Company Law art. 147.
\textsuperscript{260} Id.
\textsuperscript{262} Regulations of Issuing and Trading Shares art. 36.
\textsuperscript{263} See supra note 257 for a discussion of types of shares.
\textsuperscript{264} Provisions on Listing Foreign Investment Shares art. 4.
\textsuperscript{265} Security Law art. 79.
\textsuperscript{266} Id. art. 80.
\textsuperscript{267} Id.
\textsuperscript{268} Id. art. 79.
\textsuperscript{269} Id. art. 80.
\textsuperscript{270} This prohibition is implicit by negative implication under the Article. See supra note 200 and accompanying text.
F. Guarantees

1. Concept of the Guarantee

The term "guarantee" refers to an act whereby a third party ("guarantor") and a creditor agree that when a debtor fails to perform his obligation, the guarantor shall perform the obligation or assume liability as agreed. There are two kinds of guarantees under Chinese Law: a general guarantee, and a guarantee with joint and several liability.

A general guarantee is a guarantee in which the parties agree by contract that the guarantor shall bear liability when the debtor fails to fulfill his obligation. The guarantor under a general guarantee may refuse to assume guarantee liability unless two requirements are met. First, the creditor must have the dispute with the debtor adjudicated or arbitrated. Second, the debtor must fail to fulfill the obligation under the principal contract, despite the result of litigation or arbitration.

The general guarantee is not efficient. If a debtor fails to fulfill an obligation specified in a principal contract under the request of a creditor, the probability of the creditor's rights being satisfied through litigation or arbitration against the debtor is low. If the probability of the debtor's full performance is low, the litigation or arbitration costs incurred by the creditor is a social loss, regardless of who bears the costs. The creditor's purpose in adopting a guarantee contract is to have a guarantor who can come forward to perform the debtor's obligation or bear liability when the debtor fails to do so. Given the inefficiency in enforcing the general guarantee, some major state banks exclude the use of general guarantee in a guarantee contract.

Limited exceptions exist under which a creditor does not have to receive a court judgment or an arbitration award before he can hold the guarantor liable. The guarantor may not refuse to perform the obligation under the guarantee contract when: i) a change of the debtor's domicile has made it
difficult for the creditor to locate the debtor, and hence, expect performance of the obligation; ii) a People’s Court has accepted the debtor’s bankruptcy case and suspended the liquidation process; or iii) the guarantor has waived his right in writing and is willing to assume the guarantee’s obligation. However, these limited curative circumstances still fail to adequately address the inefficiency issue.

Compared with a general guarantee, a guarantee with joint and several liability is a guarantee whereby the parties agree in a guarantee contract that the guarantor and the debtor are jointly and severally liable for the obligation in a principal contract. Under this device, the creditor may require the guarantor to perform the obligation or assume guarantee liability within the scope of the guarantee without enforcing his right against the debtor at the expiration of the term for performance. If the parties fail to specify the type of guarantee contract or the agreement is unclear, the guarantor shall bear joint and several liability with the debtor.

2. Eligibility

The Security Law maintains that only legal entities or citizens who have the financial resources to fulfill obligations on behalf of others are eligible to act as guarantors. Under Chinese law, legal persons and legal entities are able to independently bear civil liability. By negative implication, branches and functional divisions of legal entities may not independently bear civil liability. The Security Law, therefore, prohibits branches and functional divisions of legal entities from acting as guarantors. Branches of legal entities with letters of authorization from a parent legal entity may provide guarantees within their scope of authority.

State-imposed financial eligibility restrictions for guarantees have already been criticized. Under the free market philosophy now espoused in China, the financial eligibility of a guarantor logically should be a matter of business practice, not of law; bureaucratic restrictions will only hamper China’s economic development. If a creditor feels that a prospective

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280 Security Law art. 17(3).
281 Id. art. 18.
282 Id.
283 Id. art. 19.
284 See id. art. 7.
285 Civil Law art. 37(4).
286 Security Law art. 10.
287 Id.
288 See Chen Tung-pi, supra note 21, at 94.
289 Id.
guarantor has sufficient resources to secure a debt adequately, there is little reason why external regulations should prohibit the guarantee on financial grounds. It is also difficult to believe that external parties have better information or incentives than the contracting parties. If creditors repeatedly fail to accurately assess the financial health of guarantors, serious structural problems may come to exist. For instance, persons engaging in credit transactions may not work for the best interest of their institutions. This further suggests that there are not enough contractual or market constraints to restrict their behaviors. If that is the case, a better approach is to improve the contractual arrangements (such as shareholder monitoring or control by the board of directors) and market constraints (such as in a developed managerial market or corporate control market) instead of establishing the eligibility standard. If a creditor's failure in assessing the financial position of a guarantor is due to a lack of information, a better approach is to improve market institutions. For instance, banks and other financial institutions may provide independent assessments of credit users.

A further defect of the financial eligibility provision in the Security Law is the failure to specify the consequences if a guarantor does not have the financial resources to guarantee the debtor's obligation. If a lack of financial resources invalidates the guarantee, the creditor's position will be worse off compared with the position where no financial eligibility is provided in the law; the creditor may still partially recover the credit so long as the guarantor still has some available assets. Another practical difficulty is how to determine financial eligibility. Should financial eligibility be determined at the time the guarantee is created or at the time the guarantee liability arises? As the value of the assets of the guarantor may be affected by economic conditions, fluctuations in the market may make it difficult to determine the value of the guarantor's assets. For these reasons, the financial eligibility requirement is not worth keeping in the law.

The Security Law generally prohibits state authorities from acting as guarantors. The rationale is twofold: i) most government authorities are

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290 Id.
291 Id.
292 Security Law art. 8.
allocated only a limited amount of funds, and ii) guarantees provided by governmental authorities may mix the wealth maximization goals with non-wealth maximization goals. Because of limited funds, government authorities are most likely not able to fulfill their guarantee liabilities. Strict enforcement of guarantees will disrupt the normal function of government authorities. For instance, the disposition of assets of a bureau of education or health may weaken the monitoring or control of educational institutions or hospitals. Governmental involvement in domestic commercial transactions mixes the wealth maximization goals with non-wealth maximization goals. Allowing governmental authorities to enter into normal domestic guarantee contracts contradicts reform towards a market economy because the state as a guarantor would incur ultimate financial responsibility for the debts of poorly managed enterprises. The maintenance of the poorly managed enterprises may have nothing to do with wealth maximization, but rather, everything to do with saving jobs, a non-wealth maximization goal.

Against this general prohibition, an exception is created so that state authorities may guarantee loans from foreign governments or international economic organizations to domestic users. To do that, the guarantor has to obtain the approval from the State Council. The rationale of this exception is that these loans are used by local governments or other organizations for infrastructure projects. As the investment from the projects cannot be recovered on a short-term basis, other commercial entities in China are usually not willing to guarantee the debt obligations. These loans are paid by the users who also guarantee their own obligations to the state authorities that serve as indirect borrowers. Another reason for state authorities to act as guarantors is to solve the information asymmetry problem. Foreign governments or organizations may not have adequate information about the local government, while state authorities not only have the information about the local governments, but also control these local governments.

294 These non-wealth maximization goals include the provision of healthcare, education and the expansion of employment.
296 Security Law art. 8.
297 Id.
299 Id.
300 See also KONG XIANGJUN, supra note 295, at 85.
3. **Formality and Content**

Guarantee contracts need to satisfy the requirements related to formality and content. Formality requires that a guarantee contract be in writing. In addition, the Security Law mandates that a guarantee contract shall include: i) the type and amount of the principal obligation guaranteed; ii) the deadline for fulfillment of the obligation by the obligor; iii) the type of guarantee; iv) the scope of obligation covered by the guarantee; and v) the term of the guarantee. Parties to a guarantee contract may correct any error caused by omissions related to the above content. This may suggest that an omission of a mandatory term is not strictly fatal. However, a guarantor may escape liability if the liability is not clear and no agreement can be reached after the default has occurred. Further, if an omission has misled a third party, the correction of the omission should not prejudice such a party.

Guarantors and creditors may enter into several guarantee contracts for each principal credit contract, or enter into a guarantee contract with a maximum guaranteed amount for a series of financial or trade credit transactions over a period of time. This method provides flexibility for both guarantors and creditors. In a guarantee contract, a guarantor's liability covers the principal obligation, interest, liquidated damages, compensatory damages, and expenses for realizing the creditor's rights. The Security Law, however, gives the parties the freedom to reduce or enlarge the scope of the guarantor's liability.

Unless a guarantee contract provides to the contrary, a creditor has the right to assign his rights in a principal contract to a third party during the term of the guarantee. An assignment of contractual rights only changes the parties to a contract, not the rights and duties in the contract. The assignment of a creditor's rights in a principal contract to a third party is not objectionable since the assignment normally does not increase the burden on the debtor. In addition, the assignment does not increase the burden of the guarantor. Therefore, the law requires the guarantor to continue to bear the guarantee liability within the scope of the original guarantee. In contrast,
the assignment of obligations by a debtor in a principal contract affects both the creditor and the guarantor. Because the probability of performing contractual obligations may vary from one person to another, an assignment of obligations will affect the ex ante estimation of future risks made by a creditor or a guarantor. For instance, if the substitute is less credible than the original debtor, then the guarantor’s position will be worse off since the possibility that the guarantor will be liable increases. For these reasons, a creditor must obtain the written consent from the guarantor to allow a debtor to assign the obligation for the term of the guarantee.\textsuperscript{310} Otherwise, the guarantor will no longer bear guarantee liability.\textsuperscript{311} For similar reasons, a variation of the principal contract will affect the position of a guarantor and, therefore, the variation must obtain the guarantor’s written consent.\textsuperscript{312}

4. Terms of Guarantee and the Adoption of Guarantee

Chinese law provides a very short period within which a creditor may pursue a guarantor. In a contract with a general guarantee, the guarantee period is six months from the date of expiration of the term for performance of the principal obligation, unless otherwise agreed.\textsuperscript{313} If the creditor fails to file a suit or apply for arbitration against the debtor within this deadline, the guarantor is released from the guarantee liability.\textsuperscript{314} However, if the creditor has filed a suit or applied for arbitration, the term of guarantee will be redetermined.\textsuperscript{315} A creditor protected by a guarantee with joint and several liability can pursue the guarantor if the probability of recovering the debt from the debtor is low; consequently, the creditor has six months, from the date of expiration of the performance of the principal obligation, within which he can hold the guarantor liable for the guaranteed liability.\textsuperscript{316}

Under Chinese law, if a debtor secures an obligation by both a personal guarantee and collateral, the guarantor must bear guarantee liability for the part

\begin{footnotesize}
\begin{enumerate}
\item Id. art. 23.
\item Id.
\item See id. art. 24.
\item Id. art. 25.
\item Id.
\item Id.; Civil Law art. 140. The combination of Article 25(2) of the Security Law and Article 140 of the Civil Law requires the term of guarantee to restart from the date of litigation or arbitration. However, if the litigation or arbitration lasts longer than six months, the creditor’s right for guarantee may be deprived without any fault on his part. A likely interpretation is that the term of guarantee reopens from the conclusion of the enforcement of the judgment or award. See \textit{Interpretation of the Security Law of the PRC}, supra note 99, at 35.
\item Security Law art. 26.
\end{enumerate}
\end{footnotesize}
of the obligation not secured by the collateral.\textsuperscript{317} If the creditor waives the obligation secured by the collateral, the guarantor is exempt from guarantee liability to the extent of the rights waived by the creditor.\textsuperscript{318} This provision contradicts the liberal position in the Security Law that parties to a guarantee contract may specify the scope of obligation covered by the guarantee.\textsuperscript{319}

The guarantee is currently popular in China.\textsuperscript{320} When manufacturing enterprises borrow money from financial institutions, the financial institution may require the manufacturing enterprises to find guarantors. For instance, the People's Construction Bank of China requires that all loans provided by the Bank should be guaranteed unless its rules provide otherwise.\textsuperscript{321} Another commonly used method is to require banks to act as guarantors for other manufacturing or service enterprises.\textsuperscript{322} In this way, normal commercial credit transforms into bank credit. Considering that major state banks have a nationwide presence, they are more credible than ordinary companies. The banks' position on guarantees is particularly important in China given that chain defaults among ordinary enterprises are enormously serious.\textsuperscript{323} In addition, major state banks are more credible on international markets. When banks act as guarantors for foreign or domestic credit providers, they normally require the credit-users to have bank accounts with them. These banks may also require collateral from the domestic credit-users. Different banks have issued internal rules to respond to such demands. For instance, the People's Construction Bank of China issued the Provisional Measures on Guarantee Practice in January 1992.\textsuperscript{324} The Provisional Measures deal with instances when the bank's customers or guarantee applicants fail to fulfill their obligations;\textsuperscript{325} in such cases, the People's Construction Bank assumes guarantee liability for the payment of Chinese currency.\textsuperscript{326}

\begin{thebibliography}{99}
\bibitem{317} Id. art. 28.
\bibitem{318} Id.
\bibitem{319} See id. art. 21.
\bibitem{321} Measures Concerning Secured Loans art. 3.
\bibitem{322} \textit{Kong Xiangjun}, supra note 295, at 9.
\bibitem{323} Funds constitute a major element of the predicament which state enterprises will have difficulty escaping. \textit{Market Econ. Herald}, Sept. 11, 1998. The problem of chain default, also called triangle debt, has become very serious in the 1990s in China. A survey of 100 big enterprises in Liaoning Province shows that, because of triangle debt, accounts receivable which had not been collected increased by 28 times from 1985 to 1995. \textit{Id}.
\bibitem{324} \textit{Kong Xiangjun}, supra note 295, at 9.
\bibitem{325} Id.
\bibitem{326} Id.
\end{thebibliography}
When banks or other enterprises act as guarantors for the payment of foreign currencies to foreign entities for other domestic credit users, special rules provided by the People’s Bank of China apply. The People’s Bank of China first issued the Provisional Measures Governing the Issue of Foreign Exchange Guarantees by Domestic Institutions in China in 1987. The 1987 Provisional Measures were amended in 1991 and further amended in 1996. The title of the Provisional Measures has been changed to Procedures of Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China (“The Procedures”). In 1998, the State Administration of Foreign Exchange (“SAFE”) promulgated Implementing Rules on Procedures of Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China (“Implementing Rules”). As guarantees to foreign entities are subject to more restrictions than guarantees to domestic institutions, a separate treatment of the Procedures and the Implementing Rules will be provided in the following section.

III. LEGAL PROVISIONS GOVERNING SECURED TRANSACTIONS WITH FOREIGN ENTITIES

In order to control foreign exchanges, legal provisions governing security devices to foreign entities by domestic institutions are restrictive. Restrictions include eligibility requirements for the security provider and security applicant and the inclusion of provisions concerning the rights of the security provider. As will be discussed, many of the restrictions and mandated provisions are defective when subject to careful examination.

SAFE and its local branches have a wide range of powers to control secured transactions. The Procedures, which incorporate many provisions of the Security Law, provide a basic framework for SAFE and its branches to effectuate their responsibilities. Although the Procedures only authorize SAFE to interpret the provisions in the Procedures, SAFE issued the Implementing Rules in 1998. The Implementing Rules considerably increased the substantive details

330 See infra note 357 and accompanying text & Part III.E.
relating to the operation of the system. Discussion in this section is largely based on the Procedures and the Implementing Rules.

A. The Concept and Its Scope

The aforementioned legal provisions govern instances where an organization within the PRC (the security provider) makes a guarantee to a foreign party outside the PRC or a foreign invested financial institution within the PRC (the beneficiary). These provisions exist to help ensure that if a debtor (the secured party) fails to fulfill its obligations, the security provider will perform the obligations and the beneficiary will realize its security interest. The provisions govern the following types of secured transactions: i) finance security; ii) lease financing security; iii) security under a compensating trade agreement; and iv) security for projects outside the PRC. In addition to these four major categories, a catchall category covers all other secured transactions not belonging to the previous four categories.

The first type of secured transaction covers finance security. Finance security refers to securing the repayment of the principal together with the interest through a security provider in order for a secured party to obtain financing from a beneficiary. Acceptable means of financing a secured party include borrowing, issuing securities (excluding shares), authorizing overdrafts, allowing deferred payments, and establishing a bank credit line.

The second type of transaction is a lease financing security. A lease financing security is a security provided by the security provider to a lessor for the importation of equipment by a lessee. When the lessee fails to pay rent in accordance with the lease contract, the security provider is responsible for the rent.

A third type is a security under a compensating trade arrangement. These utilize performance bonds in foreign exchanges and performance bonds in-kind. Performance bonds in foreign exchanges establish a security under the following circumstance: If an importer fails to deliver goods, after having

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331 The guarantee may be in the form of a letter of guarantee, a standby letter of credit, a promissory note, a bill of exchange, or a mortgage or pledge.
332 The Procedures art. 2; Implementing Rules art. 4.
333 The Procedures art. 2; Implementing Rules art. 5(5).
334 Implementing Rules art. 5(1).
335 Id.
336 The Procedures art. 2.
337 Implementing Rules art. 5(2).
338 Id.
339 The Procedures art. 2.
340 Implementing Rules art. 5(3).
received the imported equipment in conformity with a contract, to the
equipment supplier or a designated third party and is unable to pay the price
for the imported equipment plus interest in foreign currency, the security
provider will compensate the equipment supplier the amount secured, together
with interest and other relevant costs. Performance bonds in-kind are not
subject to the Implementing Rules since no payment in a foreign currency is
required.

Yet another type of security financing concerns the use of a security or
securities for projects outside the PRC. In this situation, the security
provider undertakes with a foreign entity, who invited the tender, that if a
successful tenderer fails to execute the contract or fails to perform the contract
within the specified time after having won the tender or executed the contract,
the security provider will pay the amount secured to the foreign entity.

B. Qualifications of Security Providers and Secured Parties

The Procedures govern security providers of Chinese financial
institutions which are authorized to provide security to foreign parties and
security providers of non-financial legal entities, including, domestic
enterprises, and foreign investment enterprises (excluding foreign financial
institutions in China). These security providers have the ability to fulfill debt
obligations.

For financial institutions, guaranteed sums may not exceed twenty times
the amount of the institution’s own foreign currency funds. A further
restriction on the amount a financial institution may guarantee is the ceiling on
loans to investments in a single enterprise. Under this limitation, the sum of a
loan in a foreign currency provided to a single enterprise, plus fifty percent of
the amount of the foreign exchange secured and the foreign exchange
investment (equity contribution), may not be greater than thirty percent of the
financial institution’s foreign currency funds.

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341 The Procedures art. 2.
342 Id.
343 Id. art. 2.
344 Implementing Rules art. 5(4).
345 The Procedures art. 4.
346 Implementing Rules art. 21(1). The sums reflect: 1) the amount of obligation in a foreign currency
secured to foreign entities; 2) the amount of obligation in a foreign currency secured within the PRC; and, 3)
the outstanding amount of the foreign currency debts.
347 This reflects the probability that the security provider will be asked to assume liability for 50% of
the amount secured or guaranteed.
348 Implementing Rules art. 21(2).
Non-financial legal entities are subject to different rules. For them, the outstanding amount under a security to foreign parties may not exceed fifty percent of its net assets and may not exceed its foreign exchange revenue of the preceding year. These entities are divided into trade-type enterprises and non-trade enterprises. When a trade-type domestic investment enterprise provides security to foreign parties, the ratio of its net assets to its gross assets may not be less than fifteen percent. On the other hand, when a non-trade domestic enterprise provides security to foreign parties, the ratio of its net assets to its gross assets may not be less than thirty percent. Trade or non-trade enterprises are determined according to which type of business is specified on the business license issued by the State Administration for Industry and Commerce or its branch.

There may be several types of secured parties. They include: i) domestic enterprises within the PRC; ii) foreign investment enterprises; iii) wholly-owned subsidiaries registered outside of China but owned by organizations within China; and iv) enterprises in which Chinese parties have equity ownership interests.

Secured parties are subject to financial eligibility requirements. If a secured party is a trade-type enterprise outside the PRC, the ratio of its net assets to its gross assets may not be less than ten percent. With respect to a secured party that is a non-trade-type enterprise outside the PRC, the ratio of its net assets to its gross assets may not be less than fifteen percent. Moreover, the secured party may not be a loss-making enterprise. This provision considerably reduces the probability that a loss-making enterprise may obtain credit. In the business world, enterprises lose money all the time, albeit most only on a temporary basis. To restrict credit, even on a secured basis, to these enterprises reduces the chance for them to recover. Thus, creditors may continue to lose the opportunity to recover loans lent to the enterprise in the past. Whether a creditor should continue to provide loans secured by collateral is a normal business decision. The decision to loan should remain with the creditor and not the regulators.

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349 Id. art. 22.
350 Id.
351 Id.
352 Id.
353 Id.
354 Id. art. 6.
355 Id. art. 17(1).
356 Id.
357 Id. art. 17(2).
C. Relevant Authority and Its Powers

SAFE and its branches and sub-branches are authorized by the People’s Bank of China to regulate the use of secured transactions with foreign entities. Consequently, they must examine, approve, administer, and register these transactions, which are subject to approval by SAFE and its branches.

There are only four exceptions to the requirement of obtaining SAFE approval. First, approval by SAFE is not required when wholly foreign-owned enterprises provide security to foreign parties. Second, SAFE’s approval is not necessary where a mortgagor mortgages his or her own property to a foreign party for an obligation. However, the mortgagor in such a case still needs to register the transaction with SAFE. The Security Law may additionally require separate registration with other relevant authorities. In addition, a domestic enterprise must provide documentary evidence of such approval for it to incur foreign debts with the blessing of SAFE. Third, a pledgor does not have to obtain the approval of SAFE if it pledges its own movable property or right to a foreign party for its own obligation. Similar to a mortgagor, the pledgor must provide documentary evidence that it has been approved to incur foreign debts. Registration of the security transaction with SAFE is also required. Moreover, a separate registration under the Security Law may be necessary. Fourth, when a wholly Chinese-owned bank meets the financial eligibility requirements discussed previously, it may issue guarantees on its own authority without seeking the approval of SAFE or its branch. Such guarantee contracts become effective on the date of the conclusion of the contract.

The division of authority to examine and approve secured transactions with foreign parties has been specified by the Implementing Rules. Transactions for domestic enterprises protecting foreign parties, or for foreign investment enterprises with a term of not more than one year protecting

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358 The Procedures art. 3.
359 Implementing Rules art. 3.
360 Id. art. 8.
361 Id. art. 27(1).
362 Id.
363 Id. art. 27; Security Law arts. 42, 43.
364 Implementing Rules art. 27.
365 Id. art. 35.
366 Id.
367 Id.
368 Id. art. 36.
369 Supra notes 348 & 349 and accompanying text.
370 Implementing Rules art. 20(2).
371 Id.
foreign parties, through a security provider (excluding wholly foreign-owned enterprises) must be examined and approved by the SAFE branch of the province, autonomous region, or municipality, directly under the central government where the security provider is located. A secured transaction with a term of more than one year protecting foreign parties for foreign investment enterprises and transactions to foreign parties for organizations outside the PRC by a security provider (excluding wholly foreign-owned enterprises) must be preliminarily examined by the provincial SAFE branch. After its preliminary examination, the provincial SAFE branch then must forward the application to SAFE for examination and approval. SAFE also examines and approves a security provided to foreign parties if the security provider is among the following: i) a national, wholly Chinese-owned financial institution based in Beijing; ii) a domestic investment enterprise directly subordinate to the central authorities; or iii) a foreign investment enterprise (excluding wholly foreign-owned enterprises) that obtained its business license from the State Administration for Industry and Commerce.

When applying for approval, a security provider shall provide all or part of the following materials to the SAFE or its branch: i) the application; ii) the approval document for the feasibility study for the secured project or the approval of the secured contract by governmental authorities and other related documents; iii) balance sheets and profit and loss statements of the secured provider and secured party which have been verified by a registered accountant; iv) the contract or the letter of intent concerning the principal debt secured and other related documents; v) the security contract or the letter of intent of providing the security; and vi) other materials that SAFE or its branches require. When a wholly Chinese-owned financial institution or domestic enterprise provides security to foreign parties for a foreign investment enterprise, SAFE requires a document showing that the security obtained for the portion of the debt corresponds to the foreign party's equity contribution. This is required because a secured obligation incurred by a foreign investment enterprise is shared by the Chinese investor and its foreign

372 Id. art. 8(1).
373 Id. art. 8(2).
374 Id.
375 Id. art. 8(3).
376 Neither the Procedures nor the Implementing Rules clearly specify under what circumstances the applicants may submit partial materials.
377 Among the "other materials" is proof of ownership of a mortgaged property or pledged property and documentary evidence of the appraisal of the present value. Implementing Rules art. 9.
378 Id.
379 Id.
partner according to the ratio of equity contribution.\textsuperscript{380} The law does not allow a domestic enterprise (excluding wholly foreign-owned enterprises) to secure the obligation which should be borne by the foreign investor for the benefit of a foreign entity.\textsuperscript{381}

Approval by SAFE and its branch is also required for an extension of the term of the security\textsuperscript{382} and for fulfillment of an obligation by a security provider to a foreign party.\textsuperscript{383}

\section*{D. Registration Requirement}

SAFE and its branches have adopted separate registration systems for secured transactions to foreign parties by financial institutions and non-financial institutions.\textsuperscript{384} Financial institutions are subject to regular registration on a monthly basis.\textsuperscript{385} For securities provided to foreign parties, each institution must complete a Registration Form and a Feedback Form, and report details of the securities provided in the preceding month to the SAFE branch in the place where the financial institution is located.\textsuperscript{386} The forms must be completed within fifteen days after the end of each month.\textsuperscript{387} Non-financial legal entities are subject to registration on a case-by-case basis.\textsuperscript{388} Within fifteen days from the date of the conclusion of a security contract, the security provider must complete a Registration Form and obtain a Registration Certificate from the SAFE branch in the place where the security provider is located.\textsuperscript{389}

Failure to obtain approval from, or register with, SAFE or its branches will have legal consequences. First, under Article 48 of the Implementing Rules, if a security provider grants security to a foreign party without having obtained approval when required, its contract with the foreign party shall be void.\textsuperscript{390} Second, if a security provider has provided security to a foreign party without registration with SAFE or its branch, SAFE or the branch will not

\begin{itemize}
\item \textsuperscript{380} Joint Venture Law art. 4.
\item \textsuperscript{381} The Procedures art. 8(3). Similarly, a secured provider shall not provide any security for the registered capital of a foreign investment enterprise. To allow that is to insure the insolvency of such an enterprise. See The Procedures art. 8(3).
\item \textsuperscript{382} Implementing Rules art. 12.
\item \textsuperscript{383} Id. art. 41.
\item \textsuperscript{384} Id. art. 39.
\item \textsuperscript{385} Id. art. 39(2).
\item \textsuperscript{386} Id.
\item \textsuperscript{387} Id.
\item \textsuperscript{388} Id. art. 39(1).
\item \textsuperscript{389} Id.
\item \textsuperscript{390} Id. art. 48.
\end{itemize}
approve the purchase and remittance of foreign exchange when the security provider has to fulfill its security obligation to the foreign party.\(^{391}\) Therefore, the registration of a mortgaged or pledged property with a relevant authority specified in the Security Law is not adequate if the Implementing Rules require the registration of the mortgage or pledge with SAFE or its branch.\(^{392}\) If the security provider fails to register such a mortgage or pledge, SAFE or its branch will not allow the security provider to convert the proceeds from an auction or sale from Chinese currency into foreign currency and remit the foreign currency out of the PRC.\(^{393}\)

E. Mandated Rights of Security Providers

Added to these many restrictions is a further requirement that a security contract should specify the rights of the security provider.\(^{394}\) According to this requirement, a security provider has the right to monitor the funds and property of the secured party.\(^{395}\) After the fulfillment of the secured obligation, the security provider is entitled to seek compensation from the secured party.\(^{396}\) In addition, if the failure of performance by the beneficiary leads to the exemption of obligations of the secured party, the security provider will be automatically released from his or her security obligation.\(^{397}\) The security provider also has the right to demand that the secured party provide him or her with counter-security or a corresponding mortgage.\(^{398}\) Finally, the security provider has the right to a contractually agreed fee for the guarantee of security.\(^{399}\)

The provisions that provide for mandated rights of security providers are very paternalistic. The types of rights the security provider has should be a matter of agreement between a security provider and a secured party. The position of the law indicates that, although China has moved to a market oriented economy, the mentality of the law-makers still remains very much the same. Although many banks and enterprises are state-owned, the managers of these banks and enterprises may not work for the best economic interest of the banks or enterprises. A better approach is to deal with the source of the

\(^{391}\) Id. art. 42.
\(^{392}\) Id. art. 49.
\(^{393}\) Id. art. 42.
\(^{394}\) The Procedures art. 13; Implementing Rules art. 45.
\(^{395}\) Id.
\(^{396}\) Id. art. 45(2).
\(^{397}\) Id. art. 45(3).
\(^{398}\) Id. art. 45(4).
\(^{399}\) Id. art. 45(5).
problem. Privatization, which is a word never used in official documents, of some of these banks and enterprises and improvements in market institutions will provide better incentives and, therefore, will be more effective than requiring the insertion of rights of guarantors in security contracts. A further problem is that the law, originally concerned with problems faced by a few banks and enterprises, applies to all banks, including many regional banks and some commercial banks attached to commercial enterprise groups and enterprises, not just state-owned enterprises.

IV. CONCLUSION

What was unthinkable in the past is now quite common. Within a period of twenty years, China has developed a sophisticated understanding of the many security devices adopted in the West. In addition, the dian is a security device unique in the world. These devices are currently widely used and serve useful, efficient purposes in China's modernization program.

Nevertheless, the present Chinese laws have serious flaws. Contractual freedom of the parties to secured transactions is still greatly limited. Legally mandated financial eligibility and the provisions for security providers' rights indicate that lawmakers still have a planning mentality. Measures adopted by laws and regulations do not truly address some fundamental structural problems, but only attempt to solve surface problems. Lawmakers still do not fully understand some basic concepts utilized in North America, such as the attachment and perfection of security interests. This creates confusion regarding the conflict among the rights of the contractual parties, the secured parties, and third parties. Further improvements and refinements are necessary if the law on secured transaction is to achieve the purpose of efficient utilization of the scarce financial resources urgently needed for China's economic development.