

## Issues Deserving Companies' Attention in Mortgaging Activities in the Forthcoming Era of the Civil Code

— *1<sup>st</sup> Interpretation of the Real Rights*

### ❖ Overview of the Civil Code

Adopted by the third Session of the 13th National People's Congress of the People's Republic of China, the Civil Code of the P.R.C. was promulgated on May 28, 2020 and takes effect on January 1, 2021. There are seven parts constituting *the Civil Code*: the General Principles, Real Rights, Contracts, Personality Rights, Marriage and Family, Succession and Tort Liability, in addition to the Supplementary Provisions. While maintaining the basic civil system set up by the previous laws such as the Contract Law, the Real Right Law, etc., the Civil Code makes significant progress by further highlighting the autonomy of private law as the core idea of civil law and through providing more effective protection of the economic life of citizens and enterprises.

Hypothecation, as an important means of financing for companies and individuals, plays a significant role in the commercial operation of businesses. The questions such as how companies and individuals should make good use of their assets for the purpose of financing and how creditors may protect their rights as mortgagees and avoid economic loss have become the primary concerns that need addressing promptly with the prospective implementation of *the Civil Code*. This issue of our New Law Express mainly introduces the amended and newly added contents in *the Civil Code* regarding “hypothecation as a means of guarantee”, and makes a brief analysis of the corresponding impact on companies.

### ❖ Key Contents

#### I. Enabling a mortgator to transfer the mortgaged property without the

### **mortgagee's consent**

According to the Article 191 of *the Real right law P.R.C.(2007)*, a mortgagor shall not transfer the mortgaged property during the mortgaging period in the lack of the consent of the mortgagee. However, this rule is changed by the Article 406 of *the Civil Code*, which provides that transferring a mortgaged property no longer requires the prior consent of the mortgagee and that the mortgagee's right is not affected by the transaction. This is a significant change to the Article 191 of *the Real right law (2007)*.

In short, after establishing a mortgage over his certain property, a mortgagor does not lose the right to dispose of the mortgaged property. The mortgagor retains the right to transfer the property freely, as long as a timely notification is served to the mortgagee. This is an implication that *the Civil Code* encourages transfers of mortgaged properties, under the condition of ensuring transaction security. According to the *Civil Code*, where a mortgagee can prove that his right is harmed by the assignment of the mortgaged property, he may require the mortgagor to pay off the debt in advance with the money obtained from such assignment or place the money in escrow. The money exceeding the creditor's rights shall be attributed to the mortgagor, and the gap shall be paid off by the mortgagee.

### **Impact on the operation of companies**

When a company mortgages its own asset, a huge gap usually exists between the actual value of the collateral and the financing amount, and it is not easy to use the differential part to finance due to the existence of the mortgage. Under the *Civil Code*, however, companies can make better use of their mortgaged assets to finance by transferring these collaterals. Again, it is worth reminding that a timely notification of the assignment of the collaterals should be served to the creditor/mortgagee.

In the scenario where a company is the mortgagee, it should pay more attention to the status and registration information of the collateral, and communicate with the mortgagor and the mortgagee transferee in an effective manner. Alternatively, a prior agreement can be concluded with the mortgagor, ensuring the company(mortgagee) be paid in priority with the the money obtained from the transfer of the collateral. Once there is evidence that the assignment of the collateral may harm the company's right, it shall request the mortgagor to pay off the debt in advance with the money obtained

from such assignment or place the money in escrow.

From another perspective, if a company plans to buy an asset, it should conduct due diligence to ascertain its actual value and status, such as whether a mortgage exists on the asset. If a mortgage is found to have been established on the asset, the company (assignee) should seriously evaluate the potential risk in comparison with the price at which the asset is intended to be bought.

## **II. Incorporating future property into the scope of guarantee which expanding the scope of company financing**

In order to further increase the means of secured financing, the *Civil Code* has adjusted the relevant provisions of the secured property. Firstly, Articles 400 and 427 of the *Civil Code* have narrowed down the mandated description of the secured property in a security contract. Instead of elaborating the basic information of the hypothecated or pledged property such as the name, quantity, quality and status in accordance with the *Real Right Law*, now only a general description, i.e. the name and quantity of the secured property, is required to provide. Secondly, the scope of accounts receivables eligible to pledge has been extended to “existing or future” accounts receivables by the provisions of Article 440 of the *Civil Code* and Article 2 of the *Measures on Registration of Pledged Accounts Receivable*.

To sum up, the *Civil Code* has made it clear that future property can be included in the scope of security. In other words, it is allowed to pledge “future accounts receivables”, or to hypothecate “existing or future production equipment, raw materials, semi-manufactures and products”.

### **Impact on the operation of companies**

In recent years, in order to enhance the liquidity of corporate assets, the national and local-level governments have been vigorously promoting corporate financing through the pledge of accounts receivables. After the issue and implementation of the *Civil Code*, the “future high-quality assets” held by the enterprise will be included into the scope of secured property, providing a more convenient and efficient channel for corporate financing. However, according to the existing disputes over pledged accounts receivables, how to effectively control and manage the hypothecated or pledged “future properties” will become the key issue when it comes to risk

prevention in corporate financing, due to the liquidity and uncertainty of future property.

### **III. Provisions on the potential concurrency between hypothecation right and pledge right are newly added**

Article 415 of *the Civil Code* stipulates that where both a mortgage and a pledge are established on the same property, the sequence of repayment from the proceeds of the auction or sale of such property shall be determined according to the time of registration and delivery.

The *Real Right Law* and *Security Law* currently implementing in China have no provisions on the potential concurrency between the mortgage right and the pledge right, not to mention the sequence of repayment if both rights are co-existed. However, Article 79 (1) of the *Interpretations of the Supreme People's Court on Several Issues Concerning the Application of the Security Law of the People's Republic of China* states that if the same property is encumbered by both a statutorily registered mortgage and a pledge, the mortgagee ranks above the pledgee in receiving payment.

The provisions of Article 415 of the *PRC Civil Code* now fill the legal vacuum in the *Real Right Law*, which has explicitly expressed that registration and delivery have the same effectiveness as ways of demonstration. It also clarifies the sequence of repayment on the potential concurrency between the mortgage right and the pledge right. It is conducive to the equal protection of mortgage and pledge, as well as resolve the disputes of the parties over the sequence of rights.

#### **Impact on the operation of companies**

In real practice, financiers often seek for financing by setting up both mortgage and pledge on the same property. The mortgagee should strengthen the awareness to file registration regarding mortgage of the movable property, and avoid the consequence of actually being unable to obtain repayment due to failing to handle registration or timely registration, thus being inferior to the pledgee. The pledgee should control and possess the pledges in time, and pay attention to properly preserve the evidence of the completion of delivery and the actual possession of the pledges, especially in the case of entrusting a third-party to supervise.



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