

JunHe's Special Situations team led by **Catherine Miao** has been actively involved in the special situations and alternative investment practice since 1999 and has been at the forefront of providing legal services in this area in China. The team has represented numerous landmark cases in the market such as representing a financial AMC in the first foreign investment in the disposition of non-performing assets in China in 2002, and representing Citigroup Global Markets Asia Limited in the first acquisition by a foreign investor of a NPA portfolio through buyout in China in 2004.

We have advised financial AMCs, local AMCs, investment banks, commercial banks, special situations funds, mezzanine funds, private credit funds, hedge funds, real estate companies, trusts, large private AMC, asset exchanges and large non-financial businesses, on various special situations transactions, including acquisition and disposition of NPLs, acquisition and restructuring of distressed businesses, debt to equity swaps, cross-border acquisition financing, structured financing, leveraged financing, direct lending, acquisition of distressed listed companies, and other investments including turnaround investments, investment in bailout funds, investment in property at court auctions, investment in bankruptcy reorganization, alternative investment, other high-yield investments and the financing of debt and equity in distressed and opportunistic situations. Our representation has involved special situations transactions with an aggregate asset book value of more than RMB 100 billion.

We have been sharing our insight in the special situations market in China on a weekly basis, and

this newsletter assembles all articles we published in **December 2021** for your easy reference.

I. Can NPL Investors Approach the Debtor's Directors for Debt Repayment?

(First published on JunHe's LinkedIn page on 1 December 2021)

In order to increase the chance of NPL recovery, as well as seeking the possibility of pursuing against the debtor's shareholders (see *China Special Situations Insight Volume 1, Issue 5*), in certain circumstances NPL investors may turn to the debtor's directors.

In general, a director of a company is only liable for his/her performance of duties towards the company and its shareholders and do not bear such liabilities to the company's creditors. However, it is possible for creditors to directly claim for a director's personal liability for a company's debt when he/she fails to perform his/her fiduciary duties with respect to the shareholders' capital contribution and statutory obligations during liquidation to the detriment of the interests of the creditors, which are outlined below:

- **Failure to supervise the shareholders' capital contribution obligations**

(1) A shareholder defaults payment on their capital subscribed at the time of the company's increase of capital

As required by the fiduciary duties provided in PRC Company Law, directors are generally responsible for supervising and procuring

shareholders to make full and timely payments for their subscribed capital. In accordance with the judicial interpretation promulgated by the Supreme People's Court of the PRC, in terms of the capital subscribed at the time of the capital increase of the company, if a creditor is able to prove to the court that (a) a shareholder defaults payment on their subscribed capital upon the expiration date set out in the articles of association, (b) the directors, who are aware of such default, have the ability but fail to make calls upon such shareholder in respect to their outstanding amount of subscribed capital in accordance with the articles of association of the company, and (c) such non-action by the director has jointly caused damages to the company's creditors by allowing such damages to occur (the **"Capital Increase Scenario"**), the company's creditors may thus seek to hold the directors jointly and severally liable for the debt the company owes them to the extent of the outstanding amount of subscribed capital.

(2) A shareholder defaults payment on their capital subscribed at the time of the establishment of the company

It is not explicitly provided in Chinese laws or regulations that a creditor is legally entitled to hold the directors personally liable for a company's debt in the circumstance whereby the directors fail to fulfill their fiduciary duties to make calls upon shareholders in respect to their outstanding amount of capital subscribed at the time of establishment of the company (the **"General Scenario"**).

However, in judicial practice, some decided cases indicate that the courts have expanded the interpretation of the explicit rule regulating the Capital Increase Scenario above-mentioned to the effect that the directors may also be held jointly and severally liable to a creditor for the company's debt in a General Scenario. According

to a civil judgment issued by the Supreme People's Court of the PRC in 2019, the judges were of the view that the obligations of the shareholders to pay in their capital subscribed at the time of the establishment of the company are the same as those at the time of a capital increase of the company, thus the obligations of directors to supervise and procure shareholders to contribute their capital shall not be treated differently. However, it is worth noting that China is a nation that does not follow case law and a different court may hold a different opinion in a specific case.

- **Providing assistance for the withdrawal of paid-in capital**

Capital withdrawal is strictly prohibited under PRC Company Law, and it is deemed to impair the liquidity of the company thus damaging the interests of creditors. If a shareholder commits capital withdrawal with the assistance of a director, the director may be personally held jointly and severally liable with the shareholders for the company's debts to the extent of the amount of withdrawn capital and interest accrued thereon.

- **Misconduct during company insolvency**

When a company enters liquidation, a director acting as a member of the liquidation committee shall fulfill the statutory obligations in the interests of the company's creditors. If a director damages the interests of the company's creditors through any action or omission, they may be personally held liable for the debts that the company owes to the creditors. An example of this is maliciously disposing of a company's property after a company's dissolution or being negligent resulting in the loss of company records, making the company's liquidation impossible.

II. How to Investigate the Ranking of Security Interest on Real Property in NPL

Transactions?

(First published on JunHe's LinkedIn page on 8 December 2021)

The security interest on a mortgaged real property is considered the most significant source of recovery by many NPL investors. If there is any mortgagee with a prior ranking security interest on the same mortgaged property (the “**Senior Mortgagee**”), the investor could only get repayment from the disposal proceeds of the property after the repayment of such Senior Mortgagee. Therefore, an undiscovered Senior Mortgagee may have a critical impact on the returns of NPLs.

According to our own experience, we have outlined some of the major approaches for legal investigation on the ranking of security interest as below.

- **File Reviews and Online Searches**

If ranking information is explicitly indicated on the relevant mortgage right certificates or civil judgments with respect to the NPL, the investors may rely on such documents in terms of the ranking of security interest to the extent that the statements in such documents are clear and specific. The results of an online search can also be used as a reference. It is suggested to pay close attention to judgments in relation to any disputes over the mortgaged property.

In a case whereby the ranking of the mortgage on the property is not specified in the NPL files, or a judgment exists indicating that there is a prior ranking mortgagee on the property according to an online search, it is advisable to further verify the ranking information through a title search as outlined below.

- **Title Search**

Pursuant to the *Civil Code of PRC* and other relevant judicial interpretations, a mortgage over a real property is legally created upon registration with the competent authority on a real estate register. In principle, where the information on a real property right certificate or a mortgage contract is inconsistent with such records in the real estate register, the records in the real estate register shall prevail. A real property title search is to inquire and copy the records in the real estate register from the relevant authority (“**Title Search**”).

There are some points worth noting during a Title Search:

- (1) Title Search conducted by a mortgagee

In a distressed case, the possibility for the owner of real property to conduct or assist a Title Search is low. Usually the mortgagee, as the seller of NPLs, is more likely to provide the Title Search documents and provide authorization to the buyer for conducting the Title Search. However, the information and materials made available by the authority to the mortgagee is limited compared with that of the property owner. Therefore, the mortgagee will need to make a proper oral consultation with the authority in order to confirm the ranking of the security interest. Otherwise, the information obtained may not be sufficient to draw an affirmative conclusion on the ranking of the security interest.

- (2) Security interest created before 2016

Due to the two separate registration systems for building and land use rights in history, to conduct a complete and accurate Title Search requires rich experience as well as a deep understanding of the relevant laws and real property management systems. Before 2016, the registration of land use right and building were generally managed by two different governmental

departments respectively. To facilitate the unified management of real estate, a nationwide reform was promoted by the government, but it was not fully implemented in many regions until 2016, when local real estate registration centers (“**RERC**”) were set up to combine the registration of both land use right and building. RERC also serve as official windows for public Title Searches.

According to the PRC laws, where a building is mortgaged, the land use right within the area occupied by the building shall be deemed to be mortgaged along with the building automatically, and vice versa. Therefore, if the ownership title of a building or land use right was granted before 2016, the ranking of security interest can only be decided upon the obtainment of the complete real estate registers of both the land use right and building on such land (if any). However, in some places, due to the previously mentioned reformation, the registered information of land use right before 2016 has not yet been imported into the integrated data systems maintained by the RERC. Therefore, the security interest created before 2016 on the land use right is missing in Title Search results obtained from RERC in many cases. Therefore, the conclusion on ranking matters solely based on such results may be incorrect and recoveries from the NPL may be significantly impacted.

However, the above risks can be largely mitigated through further investigation and communication with other local real estate departments.

III. Key Points for NPL Investors on the Undertaking of Shortfall Payments in China

(First published on JunHe's LinkedIn page on 15 December 2021)

In a debt restructuring or regular financing transaction, it is commonplace in China for a

creditor to take an undertaking of a shortfall payment and/or liquidity support (the “**Shortfall Undertaking**”) as a strategy to improve the quality of the debt.

Before the *Civil Code*, there was no specific law regulating a Shortfall Undertaking, resulting in some controversy as to their nature. Many investors take the view that a Shortfall Undertaking does not constitute a guarantee or security under PRC laws, therefore they can be used to avoid disclosure obligations by listed companies, and it is not necessary for the obligor who provided the Shortfall Undertaking (“**Obligor**”) to obtain shareholders resolutions or board resolutions. However, on January 1, 2021, alongside the implementation of the *Civil Code*, the Supreme People’s Court promulgated on the same day a judicial interpretation regarding the application of the security system (the “**Judicial Interpretation**”), identifying the nature of Shortfall Undertakings.

- **What is a Shortfall Undertaking?**

Generally, the payment of a shortfall refers to the circumstances whereby a borrower fails to repay all the debt pursuant to the relevant agreement, and an Obligor should make up the difference between the total debt and the repaid debt. This also means that the Obligor shall repay all the outstanding debt for the borrower. The liquidity support refers to circumstances whereby an Obligor will provide the borrower with financial support, in such an amount, form, and duration as may be necessary for the borrower to perform its payment obligations. Many investors tend to believe the Shortfall Undertaking shall have no relation to a guarantee or security in the literal sense; however, in legal practice this view may not be supported by a court.

According to the Judicial Interpretation, it has been made clear that the nature of a Shortfall

Undertaking shall be determined as follows:

(a) if the relevant document manifests an intention of guarantee, the Shortfall Undertaking shall be treated as a guarantee;

(b) if the relevant document manifests an intention for an Obligor to participate in the debt or to assume the debt jointly, the Shortfall Undertaking shall be treated as a debt participation;

(c) if the relevant document manifests an ambiguous intention and it is difficult to determine the true nature as to a guarantee or debt participation, the Shortfall Undertaking shall be treated as a guarantee.

- **What NPL investors can do to protect their interests**

Given that a Shortfall Undertaking will be regarded as either a guarantee or a debt participation as the circumstances may require, it is important for NPL investors to be fully aware of the following:

(1) Internal resolutions and disclosure obligations. Under existing PRC laws, whether a Shortfall Undertaking is eventually regarded as a guarantee or debt participation, NPL investors should always require a resolution from the shareholders meeting or the board of the Obligor and require the Obligor (if it is a listed company) to publish an announcement, for the purpose of ensuring the validity of the relevant transaction documents.

(2) Guarantee type and guarantee period. Usually, the Obligor will not specify the guarantee type and/or guarantee period in the relevant agreement, because the Obligor does not want a Shortfall Undertaking to become a guarantee. In this circumstance, it would be detrimental to NPL investors if a Shortfall Undertaking is regarded as

a guarantee, because according to existing PRC laws, the guarantee shall become a general guarantee automatically (rather than a joint and several liability guarantee) with the guarantee period being six months only upon maturity of the debts.

(3) Clear wording. Given that the intention expressed in the relevant document will determine the nature of the Shortfall Undertaking, it is advisable for NPL investors to use clear wording in all transaction documents to express their true intentions as to minimize potential disputes.

IV. Fast-tracking to Enforce Security over Real Estate in China: Special Procedures for the Realization of Security Interests

(First published on JunHe's LinkedIn page on 22 December 2021)

In the interest of recovering NPLs quickly, many investors are exploring alternative routes to enforce security over real estate apart from the regular Chinese court proceedings. Upon an amendment to the *Civil Procedure Law* on 31 August 2012, a special procedure for the realization of security interests ("**Special Procedure**") came into view and became a popular solution in the China NPL market for its efficient and simple nature.

Upon the default of a borrower under a loan agreement, the relevant creditor may initiate the Special Procedure to make a claim for the security interests directly in a competent court. The court will approve the auction or sale of the mortgaged property and uphold the creditor's priority in the disposal proceeds, if the parties have no substantial dispute and the conditions for realizing the security interests are satisfied. Compared with regular litigation, the Special Procedure will be proceeded within a shorter time

period.

- **Brief introduction to the Special Procedure**

When a creditor determines to initiate a Special Procedure to enforce security, an application shall be submitted to the court in the place of the mortgaged property or the mortgage registration. After scrutiny of the loan and the relevant security by the court, (i) if the claims have sufficient legal grounds and the parties have no substantial disputes, the court will render a court order to approve an auction or sale of the property and confirm the creditor's priority in the disposal proceeds; or (ii) if the claims do not have sufficient legal grounds or the parties have a substantial dispute regarding the security enforcement, the court will render a court order to dismiss the application for security enforcement and notify the creditor to bring a lawsuit separately.

The Special Procedure is usually closed within 30 days of the day when the court accepts and files the case, unless the timeline has been extended by the court's chief judge in special circumstances, and the court order made through the Special Procedure shall be final and unappealable, which greatly improves the overall efficiency in security enforcement. Where a creditor obtains a court order approving the disposal of the mortgaged property, the creditor can proceed with the enforcement of the security at a competent court directly.

- **Important issues regarding the Special Procedure**

Even though the Special Procedure has its own advantages, NPL investors need to be aware of the following issues which may materially affect their interests:

(1) Substantive disputes will lead to the

dismissal of an application. The court will scrutinize the loan and the relevant security before rendering the court order although the Special Procedure serves as a fast-track route to enforce security, and if there exists a substantial dispute or uncertainty on important matters, it is highly possible that the court dismisses the application for security enforcement. In practice, the underlying obligors may take advantage of this and knowingly cause substantive disputes to impede the court proceedings, in which case the Special Procedure may be terminated easily, and the investor must recover the NPLs through a regular litigation which may take a year or more to obtain an effective judgement.

(2) The Special Procedure purports to enforce security interests only. Currently NPL investors can only commence the Special Procedure to claim for priority in receiving the disposal proceeds of collateral to repay debts, because in a Special Procedure the court does not have the legal authority to hold the borrower, guarantor or other obligors accountable for the outstanding debt. To have thorough protection in respect to NPLs, the investor also needs to bring a lawsuit against the borrower, guarantor and other obligors to pursue claims and obtain an effective judgement for compulsory enforcement.

(3) Enforcement of the court order is subject to a time limit. When a court renders a court order upholding the priority in the disposal proceeds of collaterals, the NPL investor still needs to apply for enforcement of the court order within two years, otherwise the court order will be unenforceable. It is important for NPL investors to note that the court order only lays the legal foundation for enforcement which will not be proceeded automatically, thus the investors must specifically apply for enforcement of the court order to realize security interests.

Catherine Miao	Partner	Tel: 86-21 2208 6350	Email: miaoqh@junhe.com
Li Yi	Associate	Tel: 86-21 2208 6323	Email: liyi_Yi@junhe.com
Luo Chong	Associate	Tel: 86-21 2283 8382	Email: luoch@junhe.com
Gu Qian	Associate	Tel: 86-20 2805 9027	Email: guq@junhe.com
Xu Haonan	Associate	Tel: 86-21 2208 6162	Email: xuhn@junhe.com
Wang Wangjun	Associate	Tel: 86-21 2208 6376	Email: wangwanjun@junhe.com
Wan Ziqian	Associate	Tel: 86-21 2208 6336	Email: wanzq@junhe.com

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