

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 **February 2022** for your easy reference.

I. How to Determine the Scope of the Security Interest of a Real Property Mortgage

(First published on JunHe's LinkedIn page on 2 February 2022)

When it comes to enforcing a mortgage over a real property, the scope of the security interest becomes one of the main concerns for NPL investors since it has a critical effect on the total amount recoverable with priority from the mortgage. However, due to incoherent mortgage registration practices across the country, determining the actual scope of the security interest is more complicated than simply examining the mortgage contract or the real estate register.

• General Principles

According to PRC law, the mortgagee and the mortgager shall have freedom to agree on the scope of the security interest of a mortgage. When there is no concrete agreement between parties with respect to the scope of the security interest then, according to the law, the scope of the security interest in a general mortgage or the scope of the maximum claim in a maximum mortgage shall encompass the principal, interest, default penalty and damages, as well as the expenses arising from the safekeeping of the mortgaged property and enforcing the security interests.

In the PRC, the mortgage right over a real property is legally created upon registration in the

official real estate register with the registration authority where the mortgaged property is located (“**Registry**”). Ideally, the information regarding the mortgage recorded in the real estate register matches that contained in the mortgage contract. If there is a discrepancy between the mortgage contract and the real estate register, the latter shall generally prevail since the real estate register kept by the Registry serves as the most authoritative basis of the mortgage right.

- **Incoherent Mortgage Registration Practices Nationwide**

There has been some ambiguity caused by long-standing incoherent mortgage registration practices across the country. This has resulted in inconsistencies between the mortgage contract and the real estate register regarding the scope of the security interest in many regions.

In many regions, the Registry does not allow registrants to register the scope of the security interest in the real estate register. Only a secured amount in the form of a fixed number can be registered. Thus, registrants usually register the value of the principal as the secured amount, while the mortgage contract between the parties specifies a broader scope of the security interest such as interest, default penalties, damages, etc.

In November 2019, the Supreme People’s Court issued the Minutes of the National Court Work Conference for Civil and Commercial Trials (“**Minutes**”) to guide the courts in dealing with the above inconsistencies. If such inconsistency is due to the registration system/rules of the local Registry and it is a common local practice of such a region that the scope of the security interest under the mortgage contract is not recorded on the real estate register, the court shall determine the scope of the security interest based on the mortgage contract, since it reflects the true agreement of the parties. Otherwise, the court will

determine the scope of the security interest based on the records of the real estate register.

- **Unification of the Real Estate Register**

The good news is that the government is improving and unifying the real estate register across the country. In April 2021, the Ministry of Natural Resources published a standardized format of the real estate register to be mandatorily applied nationwide, in which a stand-alone column for registering the scope of the security interest is added in the real estate register. If the parties have explicitly agreed that the scope of the security interest of a general mortgage or a maximum mortgage includes the principal, interest, penalty interest, damages, etc., then the Registry shall record the same in the new column upon application by the parties.

When the unification of the real estate register is fully implemented, the records in the real estate register shall be the most authoritative in determining the scope of the security interest of a mortgage over a real property. However, for a mortgage registered before such unification, the scope of the security interest shall be determined according to the guiding rules in the Minutes taking into account the common practice of the relevant Registry at the time of registration.

II. Is the Door Fully Open for Foreign Investors to Purchase Non-performing Personal Loans in China?

(First published on JunHe's LinkedIn page on 9 February 2022)

Prior to 2021, banks and asset management companies (AMCs) in China were completely prohibited from selling non-performing personal loans. Banks could not transfer distressed personal loans to AMCs, and AMCs could not transfer any distressed personal loans to investors, unless otherwise required by policies regarding the strip of NPLs from certain state-owned commercial banks from 1999 to 2000. However, the China Banking and Insurance Regulatory Commission (the “**CBIRC**”) launched a pilot program on 7 January 2021, pursuant to which certain types of non-performing personal loans may be transferred on a bulk basis (the “**Pilot Program**”).

The Pilot Program has operated for around a year and will be revisited by the CBIRC on 31 December 2022. This means that within this year, after the authorities have tested the waters, we will find out whether they will retain, suspend, or even further adjust the rules governing the transfer of non-performing personal loans.

- **How does the Pilot Program affect the transfer of non-performing personal loans?**

By virtue of the Pilot Program, six large state-controlled banks and 12 national joint-stock banks may sell non-performing personal loans on a bulk basis to the big five AMCs (i.e., China Orient, Great Wall, Cinda, Huarong and Galaxy), Local AMCs or financial asset investment companies, but such sales shall remain subject to some important requirements as follows:

(1) Non-performing personal loans shall be

limited to personal consumption credit loans, credit card overdrafts and personal business credit loans. Personal loans with clear collateral such as personal housing mortgage loans, personal consumption mortgage (pledge) loans and personal business mortgage loans are not included in the Pilot Program.

- (2) The transfer of non-performing personal loans shall be conducted through the Center of Banking Credit Assets Registration and Circulation.
- (3) If any of the big five AMCs or Local AMCs purchase non-performing personal loans, they can only dispose of the personal loans by themselves by such means as self-collection and restructuring, but they cannot transfer such loans to anyone else.

- **How can foreign investors purchase non-performing personal loans in China?**

Currently, it is not easy for foreign investors to purchase distressed personal loans, but there are still some feasible routes to explore on a case-by-case basis.

Foreign investors cannot use an offshore SPV to purchase non-performing personal loans directly, as such a transfer may not be approved by the authorities and may be held to be invalid. However, foreign investors may incorporate an onshore platform such as a WFOE or a QFLP to make an investment in non-performing personal loans, specifically:

- (1) Given that Local AMCs are qualified buyers for distressed personal loans under the Pilot Program, foreign investors may establish a Local AMC to purchase the personal loans. If you are interested in setting up a Local AMC, please refer to our previous article *The Establishment of Local AMCs Remains Open*

to Foreign Investors in China's NPL Market: Pros and Cons (Volume 1, Issue 1).

- (2) Most of the regulations and rules restricting the transfer of personal loans are aimed at banks and AMCs. In this regard, there are other big carrots on offer from microfinance companies, third-party payment platforms (such as Ant Financial and JD Finance), pawnshop lending, asset management plans, peer-to-peer (P2P) lending and private lending. Foreign investors may participate in this market for distressed personal loans with an onshore platform, but the transaction structure is unique and should be tailor-made.
- (3) Foreign investors may use an onshore platform to cooperate with a bank or an AMC in respect to distressed personal loans owned by the bank or AMC, and any proceeds and profits could be shared among them by agreement.

III. Circumstances where the Buyer of a Real Property May Prevent the Enforcement of the Security Interest Established Thereon

(First published on JunHe's LinkedIn page on 16 February 2022)

According to our experience in relation to NPL investments, it is not unusual to see mortgaged real property under a title dispute with a third-party buyer of such property. In general, the basic principle of the priority of mortgage rights under PRC law should be observed. However, to strike a balance between the interest of the real property buyer and the security interest holder of the same property, the Supreme People's Court of the PRC has indicated that a buyer may prevent and exclude the enforcement of security interest over the real property under certain scenarios. The two most common scenarios are

as follows:

- **If the real estate is a commercial residential house in the name of the real estate developer ("Residential House")**

As an exception established to protect consumers' subsistence rights from irregularities in commercial real property pre-sales, a buyer of a Residential House is entitled to exclude the enforcement of the security interest over the same if all the following conditions are met:

- (1) the buyer has signed a lawful and valid purchase and sale contract in writing before the Residential House is attached by the court;
- (2) the Residential House is purchased for residential purposes, and the buyer has no other residential property under his/her name;

Based on our judicial research, when a competent court examines whether this item (2) is satisfied, it would take various elements into consideration, such as whether there is a residential house under the name of the buyer in the city where the Residential House in dispute is located, and whether the area of the Residential House meets his/her basic living needs.

- (3) the price paid by the buyer exceeds 50% of the total purchase price.

- **If the real estate is not a Residential House**

Though it is not clearly provided under the existing PRC laws or judicial interpretations, from our observation of relevant judicial cases, the buyer of a real property which is not a Residential House ("**Non-residential House**") may also have the right to prevent the enforcement of security

interests over the same upon satisfaction of all the following circumstances:

- (1) the buyer has signed a lawful and valid purchase and sale contract in writing before the Non-residential House is attached by the court;
- (2) the buyer already has lawful possession of the Non-residential House before it is attached by the court;
- (3) the buyer has paid the full price, or has paid part of the price as specified in the relevant contract and handed over the remaining portion for enforcement in accordance with the requirements of the court; and the registration of ownership transfer has not been completed due to reasons not attributable to the buyer.

In practice, there are different understandings with respect to item (4). Generally, a buyer may be determined to meet the condition if he or she submits the transfer registration documentation to the property registration authorities, makes a request for the transfer registration to the seller, or presents a reasonable cause for the failure to conduct the registration.

However, we also note that the courts tend to

apply stricter conditions and standards when determining the exclusion of enforcement of security interest if the buyer is a Non-residential House consumer. In this regard, it would be more difficult for a Non-residential House consumer to prevent the enforcement of security interest on the same.

Furthermore, it is worth noting that after the PRC Civil Code came into effect on January 1, 2021, a mortgagor is permitted to transfer the mortgaged property to another person during the term of the mortgage and the transfer of such property shall not affect the mortgage thereon. We will continue to monitor whether this new stipulation will affect the right of the buyer to prevent the enforcement of security interest on real property in practice and keep our clients apprised of any important changes.

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
Yang Qiao	Associate	Tel: 86-20 2805 9062	Email: yangq@junhe.com
Wan Ziqian	Associate	Tel: 86-21 2208 6336	Email: wanzq@junhe.com

This document is provided for and only for the purposes of information sharing. Nothing contained in this document constitutes any legal advice or opinion of Jun He Law Offices. For more information, please visit our official website at www.junhe.com or our WeChat public account “君合法律评论”/WeChat account “JUNHE_LegalUpdates”

