

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 biweekly basis,

and this newsletter assembles all articles we published in **November/December 2022 and January 2023** for your easy reference.

I. Revocation of Transactions in Bankruptcy: Triggering Events and Strategies

(First published on JunHe's LinkedIn page on 23 November 2022)

Distressed assets are usually intertwined with bankruptcy procedures and these have provided great opportunities for investment. However, a concern that is frequently raised is whether a specific transaction may be revoked or terminated by the bankruptcy administrators and what investors can do to mitigate such risks.

In bankruptcy procedures, once a transaction is revoked, the investor will lose its acquired target, security or financing repayment. This may require a lot of follow-up work and result in a huge loss to the investor.

• Events that trigger the revocation of transactions

Article 31 and 32 in the *Enterprise Bankruptcy Law* provide specific events whereby bankruptcy administrators shall have the right to request the revocation of transactions by a competent court.

A transaction may be revoked due to any of the following events occurring within twelve months of a court accepting the bankruptcy application against a distressed company:

- (1) the relevant assets of the distressed company are transferred without consideration;

- (2) the transaction of the distressed company proceeds at an obviously unreasonable price;
- (3) there is a provision of a guarantee or security by the distressed company for the unsecured debts;
- (4) there is a repayment of the unmatured debts by the distressed company; or
- (5) the claims are waived by the distressed company.

If a company (a) fails to repay its matured debts and (b) has insufficient assets for repayment or obviously lacks the ability for repayment, but the company still repays debts owed to specific creditors within six months of a court accepting the bankruptcy application, the relevant administrator shall have the right to request the revocation of the repayment by a competent court.

- **Strategies to manage the triggering events of revocation**

The main purpose of revoking transactions is to maintain fairness and protect the interests of all the creditors of a bankrupt company. The above triggering events are aimed at transactions in favour of specific persons rather than all creditors. It is not feasible to bypass all the triggering events and continue with the restricted transaction, but investors may adopt the following strategies to mitigate some of the risks:

- (1) Asset transfer. Where an investor intends to purchase an asset from a distressed company, it is important to obtain an appraisal report from a reputable institution and ensure the purchase price is not a great deal lower than the estimated value. Such a report may provide a solid defense for the investor if the administrator challenges the

sale.

- (2) Guarantee and security. A guarantee or security for an existing unsecured debt may be revoked by a court, but investors can obtain a guarantee or security from a distressed company for new financing.
- (3) Repaying unmatured debts. Where an investor intends to take back its financing before the maturity date, the investor may look into the loan documents and check the acceleration clause, because the loan will become matured if the investor can invoke some special or general terms to accelerate the loan.
- (4) Repaying debts owed to specific creditors. When a distressed company agrees to repay debts to a specific creditor, it is advisable as a precaution that the investor initiates litigation or arbitration to obtain an effective judicial document before receiving any repayment.

II. Will the Mortgages on Real Estate be Transferred Automatically along with the Transfer of Non-performing Loans?

(First published on JunHe's LinkedIn page on 7 December 2022)

Whether security interests may be transferred automatically along with the transfer of non-performing loans (“NPLs”) has always been a key point in transactions, and whether the mortgages on real estate will be transferred automatically along with the NPLs is the top priority for many domestic and foreign investors.

In the basic theories of the civil law, security interests are conditioned on existence of the principal claims, transferred along with the principal claims and extinguished due to extinction of the principal claims; therefore, mortgages on real estate shall be transferred concurrently with the transfer of NPLs. However, the registration of transfer of mortgages on real estate is still required under certain departmental regulations currently in effect, and while some courts held that the registration of change of mortgages must be completed, investors are doubtful whether the mortgages on real estate will be transferred automatically along with the NPLs.

- **Mortgage transfer registrations are required by some departmental regulations and courts**

According to Article 37 of the *Administrative Measures for the Mortgage of Urban Real Estate* (the “**Urban Real Estate Measures**”) promulgated by the Ministry of Housing and Urban-Rural Development and Article 69 of the *Detailed Rules for the Implementation of the Interim Regulations on Real Estate Registration* (the “**Real Estate Registration Regulations**”) enacted by the Ministry of Natural Resources, when a mortgage is transferred, the registration

for change of mortgages shall be completed. We also observed that some courts at a lower level took the view that the formality on registration of change of mortgages must be completed after the transfer of NPLs, otherwise the relevant mortgages on real estate cannot be vested in the transferee of the loans, and the transferee shall have no priority of disposal proceeds of the mortgaged properties.

The aforementioned regulations and cases have successively posed specific requirements for registrations of mortgage transfer, which, to a certain extent, heightened the worries of investors.

- **Difficulties in completing registrations for mortgage transfer in practice**

As the regulations abovementioned specifically require the registrations for transfer of the mortgages on real estate, in order to seek protections to the fullest extent, certain domestic and foreign investors ever considered registering such transfer upon acquiring the principal claims.

In practice, however, it is rather difficult to complete the registrations for transfer of the mortgages on real estate following the transfer of NPLs. One of the important reasons is that most real estate registration authorities require the mortgagors to cooperate in completing the registrations; yet once the loans become non-performing, relevant mortgagors are less likely to cooperate in any registration solely for the benefits of the creditor.

It appears that the Urban Real Estate Measures and the Real Estate Registration Regulations only took into account the registrations for mortgages transfer when claims are transferred under normal circumstances but failed to take into full account the protection for the transferee of NPLs.

- **Our observation and view: mortgages on real estate shall be transferred automatically along with the transfer of NPLs**

- (1) There is a strong and solid legal basis for the automatic transfer of mortgages on real estate along with the transfer of NPLs

According to Article 407 and Article 547 of the *Civil Code of the People's Republic of China* (the "**Civil Code**") which came into effect on 1 January 2021, where the principal claims are transferred, the mortgages securing the claims shall be transferred concurrently, unless otherwise provided for by law or agreed upon by the parties concerned; when the creditor transfers its claims, the transferee shall acquire the accessory rights related to the claims, except for the accessory rights exclusively belonging to the creditor; acquisition of accessory rights by the transferee shall not be affected due to absence of the registrations for transfer or failure in shifting possession. Meanwhile, Article 39 of the *Interpretation of the Supreme People's Court on the Application of the Security System of the Civil Code of the People's Republic of China* (the "**Security System Interpretation**") stipulates that where the principal claims are divided among creditors or partially transferred, and each creditor alleges to enforce its respective security interests to the extent of its share in the claims, such allegations shall be sustained by the court pursuant to law, unless otherwise provided for by law or agreed upon by the parties.

Given the Urban Real Estate Measures and Real Estate Registration Regulations are simply departmental regulations and enacted earlier than the Civil Code and Security System Interpretation, the latter shall prevail if there is any inconsistency.

- (2) The principle of automatic transfer of mortgages on real estate is upheld by the majority of courts in judicial practice

In judicial practice, most of the courts including the Supreme People's Court held that mortgages on real estate are accessory rights which shall be transferred along with the principal claims. The Supreme People's Court rendered the civil ruling ([2019] Zui Gao Fa Min Shen No. 5925) on 20 November 2019, explicitly stating that where the principal claims are transferred, the relevant mortgages shall be transferred concurrently unless otherwise provided for by law or agreed upon by the parties; to the extent that the mortgagor alleged that after the claims had been transferred, the transferee shall not be entitled to the priority of repayment with regard to the mortgaged property without completing the registrations for mortgages transfer, such allegation shall be groundless.

In the light of the above, we tend to believe that once a creditor transfers its NPLs, relevant mortgages on real estate shall also be transferred automatically, no matter whether the transferee of the NPLs has completed the registration for mortgages transfer, provided that the relevant creditor and mortgagor have not reached an agreement to restrict the transfer of the mortgages on real estate.

III. The Notarization of Loan Documents with Compulsory Enforceability: An Introduction

(First published on JunHe's LinkedIn page on 30 December 2022)

One of the main concerns for investors, after their acquisition of non-performing loans, is how to quickly recover the creditor's rights and dispose of non-performing assets through judicial procedures. When an investor intends to initiate enforcement proceedings, there are several types of proceedings available to obtain effective judicial documents, with which investors may further apply to the competent court.

Compared with regular procedures whereby a creditor pursues claims against a debtor through litigation, the notarization of loan documents with compulsory enforceability provides a faster way to claim relief and the judicial disposal of distressed assets.

- **A brief introduction to the notarization of loan documents**

In a loan transaction, if the lender wishes to quickly collect the debt in the event of the borrower's default, and the borrower agrees, the notarization of the loan documents with compulsory enforceability is a good option for the parties to achieve this. As a first step, when a creditor and a debtor enter into a loan agreement, mortgage contract, pledge contract or other loan documents, the creditor and the debtor should incorporate a notarization clause in each of the loan documents. This should clearly state that the parties agree to have the loan documents notarized by a public notary office with compulsory enforcement effect. If the debtor fails to perform or improperly performs the obligations under the loan agreement, the creditor shall have the right to directly apply for compulsory enforcement of the notarized loan documents

without having to go through a full trial.

As a second step, when a debtor fails to repay a debt, the creditor shall apply to the notary office for a compulsory enforcement certificate. The notary office will examine the terms of the loan agreement, and if it finds that the rights and obligations therein are clear and that the agreement involves no dispute between the parties, the notary office will prepare a notarization certificate to certify that the agreement is enforceable. The creditor may then directly apply to the court for enforcement of the notarized loan documents without having a full trial and obtaining a court judgment.

- **Advantages for creditors**

The most valuable feature of the notarization of loan documents with compulsory enforceability is that the loan document becomes directly enforceable without the need for litigation proceedings, thereby conserving judicial resources. For creditors, the advantages are as follows:

- (1) It prompts the debtor to fulfill its contractual obligations, and reduces debt default through the deterrent effect of enforcement;
- (2) In the case of a breach of contract, claims can be effectively and quickly realized because the creditor can directly apply for enforcement; and
- (3) When a claim is impaired, it can reduce attorney's fees as well as other litigation-related expenses, thereby assisting the creditor in realizing its rights relief at a lower cost.

- **General procedures for the enforcement of notarized loan documents**

In respect of notarized loan documents with compulsory enforceability, if the debtor fails to completely or adequately perform its obligation

pursuant to the loan documents, the creditor may take the following actions to apply for enforcement:

- (1) The creditor may apply to the notary office to issue an enforcement certificate, then the notary office shall investigate if any default has occurred and determine whether to issue the enforcement certificate. There is no statutory time limit for notary offices to determine whether to issue the enforcement certificate, but notary offices will usually make decisions within two weeks.
- (2) Upon obtaining the enforcement certificate, the creditor may apply to the competent court to initiate enforcement procedures within two years following the date when the creditor applies to the notary office to issue the enforcement certificate, subject to other rules of discontinuation or the suspension of the limitation for enforcement.
- (3) Generally, a creditor may apply to initiate compulsory enforcement and liquidate the distressed assets by way of a judicial auction to repay debts. Judicial auctions may be conducted offline or online.

IV. Tax Issues regarding the Disposal of Real Property through Online Judicial Auctions

(First published on JunHe's LinkedIn page on 11 January 11 2023)

Online judicial auctions have become a very popular method for disposing of the collateral and assets of debtors. Online judicial auctions are the public disposal of assets by the courts through online bidding via Internet auction platforms.

A question often raised by NPL investors regarding online judicial auctions is how the burden of taxes and fees arising from the disposal of real property (collectively, "**Taxes**") is borne and shifted between the parties. In this article, we introduce the rules and common practices of tax undertakings and highlight some of the risks for NPL investors.

- **General Rules**

To carry out an online judicial auction in accordance with the *Provisions of the Supreme People's Court on Several Issues Concerning the Online Judicial Auction by the People's Courts* ("**Online Auction Provisions**", effective from 1 January 2017), the court shall identify the burden of Taxes arising from the disposal of real property under auction conditions ("**Property**"). They will also outline this information in an auction announcement published via the online judicial auction platform ("**Auction Announcement**").

The Online Auction Provisions stipulate those taxes arising from an online judicial auction shall be borne by the buyer and seller respectively, pursuant to the laws and regulations. In the absence of any applicable provision or where such provision is unclear, the court may determine the amount and the party to undertake the tax liability, in accordance with the legal principles and the actual situation of the case. The Reply to Recommendation No. 8471 of the

Third Session of the 13th National People's Congress (对十三届全国人大三次会议第 8471 号建议的答复) issued by the Tax Bureau on 2 September 2020 reaffirmed these rules.

Taxes shall therefore be borne by the original owner of the Property (“**Original Owner**”) and the winning bidder of the online judicial auction (“**Buyer**”) respectively, according to the applicable laws and regulations. We have summarized the main categories of tax that may be incurred in the disposal of Property and the corresponding taxpayers.

Category of Tax	Taxpayer
Deed Tax	Buyer
Stamp Duty	Original Owner and Buyer
Land Appreciation Tax	Original Owner
Value-added Tax	Original Owner
Urban Maintenance and Construction Tax	Original Owner

• **Common Scenarios in Practice**

In practice, however, different courts may provide different requirements on Taxes while making the Auction Announcements. These are some of the most common scenarios for reference:

- (1) All Taxes shall be assumed by the Buyer (including but not limited to the tax incurred by the original owner for the disposal of the Property (“**Original Owner Tax**”).
- (2) The Taxes shall be assumed by the corresponding party in accordance with the relevant laws and regulations.
- (3) The Taxes shall be assumed by the corresponding parties, while the Buyer is required to advance the Original Owner Tax and then be reimbursed from the auction proceeds.

We are also aware of some examples in Beijing,

Shanghai and other cities:

- (1) **In Beijing**, the courts normally do not require the Buyer to pay the Original Owner Tax before the Buyer can obtain the ownership certificate of the Property, if the purchase price and its taxes have been paid. Usually, when the court receives funds for the Property, it will distribute all the remaining proceeds to the creditor after deducting the appraisal fee, the auction fee and the enforcement fee, all of which are usually a relatively small amount.
- (2) **In Shanghai and some other major cities**, the courts do not require the Buyer to pay the Original Owner Tax, but the Buyer must advance such tax first and then be reimbursed by the court. The court will withhold part of the disposal proceeds to reimburse the Buyer against the Original Owner Tax and then distribute all the remaining proceeds to the creditor after deducting the appraisal fee, the auction fee and the enforcement fee.

• **Risk Management and Strategies**

NPL investors may acquire non-performing loans secured by the Property and take on the role of the mortgagee (the “**Mortgagee**”) or acquire the Property through an online judicial auction and become the Buyer. The Mortgagee and the Buyer are advised to use different strategies and fully consider their options.

(1) From the Mortgagee’s perspective

In principle, the Original Owner Tax should be borne by the Original Owner but it is uncertain whether the courts will withhold part of the disposal proceeds for the Original Owner Tax (“**Withhold the Tax**”). If so, the investor will not be entitled to all the disposal proceeds of the Property as certain proceeds shall be applied to pay the Original Owner Tax.

According to the Law on the Administration of Tax Collection (税收征收管理法) (whereby taxes

become payable before the taxpayer creates a mortgage or a pledge on its property or before the taxpayer's property is liened), taxes shall take precedence over the exercise of the right of the mortgage, pledge or lien.

Therefore, we tend to believe that the Original Owner Tax will not rank ahead of mortgages on the Property, since the Original Owner Tax occurs after the creation of the mortgage. We cannot, however, rule out the possibility that a court may Withhold the Tax.

In light of the above, Mortgagees are advised to investigate the Original Owner Tax and confirm if the court will Withhold the Tax. Also, investors may want to take such risks into account when evaluating the distressed loan.

(2) From the Buyer's perspective

As stated above, some courts may require the buyer to assume all Original Owner Tax in relation to the Property in the Auction Announcement. In this event, the successful Buyer at auction will have to assume the tax.

Before attending an auction, it is important for Buyers to peruse the Auction Announcement, especially the sharing and reimbursement procedures (if any) of the Taxes. In some real estate registration centers, proof of the tax payment is a document required for the title

transfer registration of the real property. Even though the court does not require the Buyer to undertake or advance the Original Owner Tax, the Buyer may not be able to complete the title transfer of the Property if the Original Owner does not pay such taxes in a timely manner. The Buyer should take such costs and risks into consideration when offering bids at auction.

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