Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?

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Abstract

Despite the global trend in favour of a notice-filling system for secured credit advances to firms secured on personal property, China adopted new provisions embodying the essential characteristics of the English floating charge in the country’s first comprehensive Property Law in 2007. This article traces the development and essential characteristics of the floating charge in England, the reason for China’s adoption of this security device, and considers whether this transplant provides Chinese borrowers and lenders with a useful addition to credit-security system that will aid further economic expansion. We follow the legal transplantation literature to analyse the Chinese security regime, with a focus on the “fit” between the imported security device and the host environment. Our central propositions on the utility of this transplantation are supported by evidence from Chinese banks’ internal guidelines and interviews conducted with credit officers responsible for granting secured banking facilities.

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1. Introduction

Industrial expansion and the consequent demand for increased commercial credit backed by a flexible security, was the trigger for the invention of the floating charge in mid 19th century England. Over the last 150 years, the law relating to floating charges has evolved substantively in common law jurisdictions, but many fundamental problems and complexities remain. Several leading common law jurisdictions either never accepted the concept of the floating charge (e.g. the United States), or have abandoned it by reforming their personal security regime along American lines (e.g. Canada, New Zealand and Australia). Somewhat surprisingly, given the waning popularity of this venerable security
device and despite its manifold imperfections, China added new provisions embodying
the essential characteristics of the floating charge into the country’s first comprehensive
Property Law in 2007. This article seeks to describe and discuss this surprising state of
affairs, to consider the reasons for the adoption and whether this transplant provides
Chinese lenders with a useful security device to aid further economic expansion.

The article is structured as follows. Section two, reviews the existing literature
concerning legal transplants from one jurisdiction to another and provides a simple
analytical framework for determining the success or failure of such a transplant. Section
three, provides a brief examination of the nature, advantages and difficulties that pertain
to the common law floating charge. In section four, we explain the relevant credit
security rules in Chinese law before the introduction of the floating charge in 2007, the
rationale and policy reasons to explain why China chose to expand the credit security
regime, and we provide a detailed discussion of the new floating charge rules in China
including consideration of who can create such a security, the type of assets over which
security can be granted, an explanation of the vexed issue of control of secured assets,
and a discussion of the continued importance of the pledge. We also outline the
formalities required for creation, registration, crystallization of the security as well as
consideration of the issues of enforcement and priority in case of the debtor’s insolvency.
Lastly, section five concludes with a discussion of the merits of this transplantation and
whether it has been effective in achieving the objectives envisioned by Chinese
legislators.
2. Literature Review and Analytical Framework

Legal transplants are usually perceived as unilateral changes in a legal order by which one jurisdiction imports legal norms from another jurisdiction,\(^1\) and may range from the wholesale adoption of an entire system of law to the copying of a single rule. From the perspective of “utility”, legal borrowing is an inexpensive, quick and potentially fruitful source of new law.\(^2\) Berkowitz, Pistor and Richard argue that the ability to successfully adapt transplanted law to local conditions has a major effect on economic development.\(^3\) Despite general agreement on the importance of transplants in advancing legal development around the world, the construction of a theoretical framework that explains the effectiveness or otherwise of particular legal transplants is difficult. Essentially, there is little agreement amongst scholars on the feasibility of transplanting, the conditions for successful transplantation, or how to define or measure “success”. Moreover, there is little analysis of how the success or failure of legal transplants relates to the achievement of larger goals, such as economic development.\(^4\)

Nevertheless, there are several schools of scholarship that may provide criteria\(^5\) for our assessment of China’s importation of the common law security device – the floating charge. Alan Watson, one of the most prominent contributors to the legal transplant

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literature, represents one school of thought. He views law as existing apart from political and social institutions, and is primarily significant for its authoritative qualities. For Watson, “the transplanting of legal rules is socially easy” and “most changes in most systems are the result of borrowing.” Another school of thought, represented by Legrand and Kahn-Freund, hold the view that “rules cannot travel” because their meaning is culture-specific. As a result, different economic, social and political institutions between countries have determined that successful transplants are rare. Mattei, who, based on theories of comparative law and economics, suggests that legal borrowing can be best explained as a movement toward enhanced efficiency, represents a more neutral view.

In the competition of what Mattei called “the market for legal culture”, the most efficient legal doctrines are transplanted from abroad and survive around the world. Furthermore, Kanda and Milhaupt (2003) supplement existing theories by showing that the motives of the borrowing country in accepting a transplant, as well as the motives of the legal professionals charged with its subsequent application and enforcement, have implications for its success or failure. In their words, a successful legal transplant means:

“The use of the imported legal rule in the same way that it is used in the home country, subject to adaptations to local conditions. Conversely, a failure occurs

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6 Watson Alan, Legal Transplants: An Approach to Comparative Law (1993, University of Georgia Press), at 95
9 See also Kahn-Freund,1974, “On Uses and Misuses of Comparative Law,” 37 Modern L. Rev. 1
10 Mattei, supra note 2.
11 Ibid, at 8.
12 Kanda and Milhaupt, supra note 4, at 889.
when the imported rule is ignored by relevant actors in the host country, or the application and enforcement of the rule lead to unintended consequences.”

We believe that this definition, though broad and perhaps not bearing normative implications, best captures the essence of a successful or a failed transplant, that is the “fit” between the imported rule and the host environment. We posit that a legal transplantation is successful when such borrowed rules create the ‘right incentives’ to the relevant actors in the host country to achieve the intended consequences of the rule, such as to facilitate borrowing or improve efficient resource allocation. Conversely, if a rule does not appeal to the local environment, it would either remain on paper, or even worse, be captured by the relevant actors and might generate unintended negative consequences.

Hence in this article, we first review the origins and evolution of the floating charge in England, and then study the motives of China to borrow this device as well as the positioning of normative rules in Chinese secured lending framework. We then analyse whether the character of this rule in its original jurisdiction is maintained in the Chinese context, and whether the application of the rule in China serves its intended economic purpose or is likely to do so once the new security device becomes more widely known and utilized by lenders.

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13 Kanda and Milhaupt, supra note 4, at 890-891.
14 As Levitt and Dubner (2009) shows, the law of unintended consequences is among the most potent laws in existence. Government, for instance, often enact legislation meant to protect their most vulnerable charges but that instead ends up hurting them. For examples, see Levitt S.D., Dubner S.J. 2009, Super Freakonomics, HarperCollins Publishers, at pp139-40.
3. The Floating Charge in English Law

3.1 Origin of the Floating Charge

The inadequacies of the security mechanisms provided by the common law were exposed as the industrial revolution of the 19th century gathered pace. Enterprises had a voracious appetite for capital, which could not be met by the sale of shares in joint stock companies to the public particularly in relation to smaller companies that were not mature enough to undertake an initial public offering. Banks were reluctant to lend at affordable rates of interest without adequate security and the common law provided only the legal mortgage or the pledge as security devices, neither of which were sufficient to allow extended lending secured on circulating assets or book debts or future property.

In English law, pledges were of limited commercial use as security for commercial credit as the principal requirement of the pledge was physical possession of the secured asset by the creditor.\(^{15}\) Debts and future property were not transferable into the possession of the creditor and so they could not be pledged. A legal mortgage required a conveyance of the legal title of the asset to the creditor as security for the debt, which was redeemable upon repayment of the debt, and the secured property would then be reconveyed back to the debtor.\(^{16}\) A fundamental limitation of the legal mortgage was that it was impossible to utilize this security device in relation to future property as the asset was not in existence at the time of the creation of the mortgage and thus, the relevant property was incapable of being conveyed to the mortgagee by the mortgagor as he had no legal interest in the

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\(^{15}\) Coggs v Bernard (1703) 2 Ld Raym 909.

\(^{16}\) Per Lindly MR in Santley v Wilde [1899] 2 Ch 474 at 474.
asset. Latham CJ in the High Court of Australia stated the position succinctly in Akron Tyre Co Pty Limited v Kitson:

“A simple assignment of ‘future property’, i.e. of property which one does not exist or in which the assignor at the time of the assignment has no proprietary interest is completely nugatory at law.”

Fortunately, equity was not so inflexible and this was the key to the development of the floating charge. Equitable mortgages required a transfer of the beneficial title of the property to the mortgagee as security for the repayment of a debt. Importantly, equity recognized another security device – the charge – that did not involve the transfer of title to the creditor, merely the creation of an equitable proprietary interest in the asset by way of security for the discharge of a debt. This was the means by which floating security was given form.

Mid-19th century English commercial lawyers sought to provide the benefits of fixed security to lenders – priority over unsecured creditors – whilst allowing commercial corporate borrowers considerable freedom to deal with the charged assets in the ordinary course of business. Crucially, a chargor would not need to seek the chargee’s consent every time there was a disposition of a charged asset, as was required where the property was subject to a traditional mortgage or charge.

17 82 CLR 477 [1951], p 484.
18 Professor Pennington has outlined the deficiencies of the common law and how equity came to the rescue in his classic article The Genesis of the Floating Charge (1960) 23 MLR 630.
The recognition of the floating charge in the 1870’s was made possible by the acceptance of the notion that an equitable assignment of property could be acquired in the future. In *Holroyd v Marshall*, a mill owner executed a trust deed in favour of a creditor in which he charged not only all existing machinery at the mill but also any additional machinery or substitute machinery acquired in the future by the debtor and brought on to the mill premises. This was a fixed charge of existing and any future property, which was appropriated to the security, by merely being on the premises at the time of the execution of the deed or to be brought onto the mill premises in the future. Lord Chelmsford reasoned that in equity the original mortgage contract was self-executing as regards any new property in the relevant asset class that was acquired by the mortgagor and brought onto the mill premises. His Lordship held that the mortgagee acquired a proprietary interest automatically upon the happening of such an event. This position was confirmed in *Tailby v Official Receiver* where the House of Lords decided that the claim of a floating chargee prevailed over that of a trustee in bankruptcy in respect of competing claims over debts that had become due before the commencement of the bankruptcy.

The growth of manufacturing enterprises in the 19th century with a concomitant expansion of non-land assets, both tangible and intangible – generally stock in trade and book debts – created the demand to invent this new security instrument.

As advances to borrowers would need to be secured on circulating assets, this presented lawyers with a practical problem to overcome – the need for the chargee to approve each

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19 (1862) 10 HL Cas 191.
and every sale of stock or the collection of each debt or the use of the proceeds lodged in the chargor’s bank account. Lawyers sought to create an inchoate equitable interest in a shifting fund of a nominated class of assets until the security ‘crystalized’ upon the happening of contractually iterated event or the commencement of liquidation proceedings, when the security would be transformed into a fixed equitable security of the traditional type. At that instant, the floating charge would become converted into a fixed security, which, it was hoped, would be effective even against property acquired by the chargor after the commencement of liquidation proceedings.\textsuperscript{21}

The prevention of commercial paralysis, that would inevitably be caused by the common law’s strict requirements, was the rationale to describe the security as ‘floating’\textsuperscript{22}. Nevertheless, other common law jurisdictions, principally the United States, did not accept the notion that charged assets could be unilaterally withdrawn from the ambit of a valid charge without specific consent of the chargee and considered this process inimical to the existence of a secured interest in the relevant property. In\textit{ Benedict v Ratner}\textsuperscript{23} the United States Supreme Court unanimously held that the creation of a security that reserves to the chargor the right to dispose of charged property was void as against creditors and so the validity of floating charges was not recognised. However, despite American adherence to common law orthodoxy, the floating charge was exported to the

\textsuperscript{21} This was confirmed in \textit{Re Oriental Island Steam Co} (1874) 9 Ch App 557,560.

\textsuperscript{22} In \textit{Re Panama, New Zealand and Australian Royal Mail Co} (1870) 5 Ch App 318, the court recognised the ability of a company to charge its ‘undertaking’ which was construed to include all present and future property but crucially the company was allowed to deal with the charged property in the ordinary course of its business to prevent ‘business paralysis’ caused by the need to seek the specific consent from the chargee for each and every dealing with the secured property.

\textsuperscript{23} (1925) 268 U.S.353.
colonial territories of the British Empire in the latter part of the 19th century and, in particular, for our purposes, to Hong Kong.24

3.2 Characteristics of the Floating Charge

The precise definition of the floating charge has long proved illusive. Over a century ago, Lord Macnaughten in Government Stocks and Other Securities investment Co Ltd v Manila Rly Co Ltd25 opined that:

‘A floating charge is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes. His right to intervene may of course be suspended by agreement. But if there is no agreement for suspension, he may exercise his right whenever he pleases after default.’

Later, in Illingsworth v Holdsworth26 his Lordship sought to differentiate between a specific or fixed charge and a floating security:

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24 In Hong Kong, the first reference to floating charge securities is to be found in the very first Companies Ordinance (No. 1 of 1865) though the term is not used. However, Hong Kong Courts have traditionally followed the decisions of the English appellate courts on the creation, nature and effects of floating charge without substantial modification through the last 150 years and floating charges are a well-recognized form of company security.

25 [1897] AC 81 at 86.

26 [1904] AC 355 at 358.
‘A specific charge, I think, is one that without more fastens on ascertained and
definite property or property capable of being ascertained or defined; a floating
charge, on the other hand, is ambulatory and shifting in its nature, hovering over
so to speak floating with the property which it is intended to affect until some
event occurs or some act is done which causes it to settle and fasten on the subject
matter of the charge within its grasp or reach.’

One of the most oft quoted definitions of a floating charge characteristics is that of
Romer LJ in the same case in the Court of Appeal:

‘[A floating charge has three characteristics] (1) It is a charge on a class of assets
of a company present and future; (2) if that class is one which, in the ordinary
course of business of the company, would be changing from time to time; and (3)
if you find that by the charge it is contemplated that, until some future step is
taken by or on behalf of those interested in the charge, the company may carry on
its business in the ordinary way as far as concerns the particular class of assets I
am dealing with.’27

However, as we will see, the precise boundary between what constitutes a fixed as
opposed to a floating charge has remained a matter of fierce debate and controversy for
the whole existence of this security interest. Even after two land mark cases since 2000 –
Brumark28 and Spectrum29 – on the issue of the characterisation of charges, the precise

27Re Yorkshire Woolcombers Association Limited [1903] 2 Ch 284, at 295
contours of the floating charge are still not wholly settled matters of law, despite almost
140 years of refinement by the courts. This continuing controversy is primarily fuelled by
issues of priority in insolvency as floating charges, as a result of statutory intervention,
have a lower security status than that of fixed charges, so making the issue of definition
of the type of security interest one of considerable commercial significance.

3.3 Development of the Floating Charge

The enviable position of the floating charge holder in enjoying parity of treatment with
the fixed charge holder by having priority over trade and other unsecured creditors such
as unpaid workers, as well as the Crown for unpaid taxes and levies,\(^{30}\) in the event of
insolvency, was not without both judicial and parliamentary opprobrium. Lord
Macnaughten was fiercely critical of the position of floating charge holders in the 1890s
and in the leading case of \textit{Salomon v Salomon & Co Ltd} he criticized the consequences of
floating security on the basis of its inherent unfairness to unsecured creditors:

\begin{quote}
‘The unsecured creditors of A Salomon & Co, Ltd, may be entitled to sympathy,
but they have only themselves to blame for their misfortunes. They trusted the
company, I suppose, because they had long dealt with Mr Salomon and he had
always paid his way; that they had fair notice that they were no longer dealing
with an individual, and they must be taken to have been cognisant of the
memorandum and of the articles of association. For such a catastrophe as has
\end{quote}

\(^{30}\) Crown preference was finally abolished by virtue of the Enterprise Act 2002, s251.
occurred in this case some would blame the law that allows such a thing as a floating charge. But a floating charge is, too convenient a form of security to be lightly abolished. I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a certain limited time before the winding-up. But that is not the law at present. Everybody knows that when there is a winding-up, debenture holders generally step in and sweep off everything. And a great scandal it is.\textsuperscript{31}

The perceived unfair advantage enjoyed by floating charge holders as against unsecured creditors brought about statutory intervention as early as the Preferential Payments in Bankruptcy Act 1897, currently embodied in England in the Insolvency Act 1986.\textsuperscript{32} But fixed charge holders were not so affected as they continued to retain their security up to the full value of the secured asset (at least at that time, though later insolvency provisions also provided for fixed charges to be set aside in certain cases).\textsuperscript{33} The logic of this distinction was presumably that the company without specific consent could not deal with property subject to fixed charges and that the property subject to a fixed charge was not utilized in the ordinary course of business. However, raw materials bought by the company and transformed by the labour of employees to produce the company’s inventory resulting in sales of products that would generate book debts, would normally be subject to a floating charge. Consequently, the creation of preferences in favour of unpaid wages should be understood in that light. However, the preference afforded to

\textsuperscript{31} [1897] AC 22 at 37.
\textsuperscript{32} Insolvency Act 1986, s 175.
\textsuperscript{33} Setting aside of fixed charges in English law: s320 of Companies Act 1948.
liabilities due to the Crown can only be explained as a matter of expediency clothed in the garb of public interest. Ordinary trade creditors, some of whom might claim a similar interest in relation to inventory and book debts as employees, were not benefited unless they had inserted a valid retention of title clause in the contract for the sale of goods to the insolvent company.  

34 As regards priority, assuming the proper registration process relevant to the asset had been undertaken, legal fixed charges generally have priority over floating charges, even when they were created later than the floating charge, save if the floating charge embodies a restriction on subsequent creations of charges ranking in priority to or parri passu with the original floating charge and the subsequent chargee has actual notice of the restriction at the time of the creation of the later charge.  

35 Further complications regarding priority as regards the distinctions between legal and equitable charges, the lack of or late registration at the companies registry, further advances made on the security of existing charges, actual or constructive notice or invalidity as a result of fraudulent preferences are not pursued here due to limitations of space, but all of these issues may be relevant to issues of priority in specific cases. For a full explanation, reference should be made to one of the standard texts.  

36 Floating charges were also reduced in their commercial utility by further legislative intervention that began as early as 1907, to allow them to be completely disregarded in

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34 See Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd [1976] 2 All ER 552.
certain situations. Liquidators could originally avoid floating charges for a period of up to three months prior to the date of the commencement of insolvency proceedings but the current law allows the claw back period to be as long as two years from the commencement of the insolvency process.\(^{37}\) Unless new credit or new property was given in exchange for the floating charge, it will be invalid if created in favour of a ‘connected person’ within two years\(^{38}\) or within one year in respect of an unconnected person at the onset of the insolvency proceedings. But if it can be shown that the company was solvent when a charge in favour of an unconnected person was given within the one-year period, irrespective of ‘new consideration’, the charge will be protected.\(^{39}\)

Floating charges were also traditionally subordinated to the costs of liquidation\(^{40}\) but this long standing rule was overturned by the House of Lords in *Blucher v Talbot*\(^{41}\) who reasoned that as the property charged as security for advances made by the chargee to the company, the relevant property was not available to the liquidator due to the prior claims of the chargee. However, s754 of the Companies Act 2006 reversed the outcome of this case and restored the pre-existing position.

A final diminution of the commercial value of the floating charge as a useful security in England was a new provision that mandated that in insolvency proceedings, after payment of preferential creditors, a certain percentage of the value of the asset upon

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\(^{37}\) See s.245 Insolvency Act 1986.

\(^{38}\) A ‘connected person’ is defined in s 249 *ibid*.

\(^{39}\) See s 245(4) *supra*.


which the floating charge is secured must be released to the liquidator for the benefit of the general unsecured creditors.\textsuperscript{42}

These statutory diminutions in the commercial value of the floating charge have driven commercial lenders and the advisers to attempt to make their security interests ever more complex and sophisticated, to try to preserve the useful features of the floating charge to both themselves and their customers whilst at the same time endeavouring to maintain the inviolability and priority of their security.

The development of the floating charge, along side the continued existence of the traditional fixed charge, whether legal or equitable, and the intrusion of statutory limitations as to the utility of the floating charge to commercial lenders inevitably led to questions of the precise characterisation of the floating charge taking centre stage. Both the borrower and the lender desired to permit maximum flexibility to the borrower to use their assets in the ordinary course of business whilst retaining, for the bank, the security of repayment of advances untouched by the ravages of the statutory diminution in the value of the floating charge. The result was that banks and their customers sought to maintain the fiction that a fixed security was to be granted over circulating assets and their proceeds and that the parties themselves could decide on the classification of the security interest they purported to create. This position was adopted so as to benefit from the benign statutory regime as regards the superior priority of fixed charges, whilst not having to engage in the practical impossibility of the micromanaging day to day company operations was traditionally required if the security was to be classified as fixed by the

\textsuperscript{42} The Insolvency Act 1986 (Prescribed Part) Order 2003, S.I. 203/2097.
common law. Attempting to square this circle has led to voluminous litigation as to the precise boundaries and characteristics of the two types of charge. This litigious marathon was caused exclusively by the inferior treatment of floating charge security by successive pieces of insolvency legislation. The nub of the issue was whether one could persuade the court that the charge in question was fixed, if so, the lender would recover its advances to the full value of the security but if it was classified as floating (and assuming it was not adjudged invalid) the majority (if not all) of the assets’ value would be absorbed to pay the liquidators costs and to meet the claims of the unsecured creditors, so substantially reducing the value of the charge to chargee.

3.4 Distinguishing a floating charge from a fixed charge

Despite the confirmation of the floating charge as a distinct species of security interest that could only be created by a corporate entity, controversy continued to plague the precise distinction between the fixed and floating charges. Confusion was sowed particularly by the decision in Re New Bullas Trading43 when the Court of Appeal concluded that the designation assigned to the charge by the parties to a transaction could determine its juristic nature. This decision created a line of cases that evinced great uncertainty as to the correct attributes of any particular charge. Chancery lawyers and their banking clients were content to benefit from the latitude afforded by that decision, so as to operate credit facilities with maximum flexibility and least administrative cost that was afforded by the nature of the floating charge. At the same time, they sought to enjoy the superior security and priority afforded to a fixed security. Needless to say, other

43 [1994] BCLC 36
creditors principally the Crown sought a reassertion of orthodoxy in respect of the mode of classification of a charge and the crucial issue of the need for specific consent to deal in each and every transaction involving a charged asset, if the charge was to be characterised as fixed. Banks, however, wanted to retain the flexibility of not having to give consent in that way whilst retaining superior security.

This clash of interests in respect of the distinction between fixed and floating charges culminated in England with the House of Lords decision in *Re Spectrum Plus Ltd*. In this case, their Lordships unanimously endorsed the approach taken by Lord Millet in *Agnew*. Lord Millett, delivering the advice of the Privy Council, confirmed that when a charge was created, the label or declaratory expression of the parties was insufficient to determine the true characteristics of the charge. Two conditions must be satisfied. First, the terms of the charge must deprive the chargor of the power of disposal of the charged assets and those assets must not be capable of being used in the chargor’s business without the specific consent of the chargee. Secondly, it must be further shown that control was real and not merely hypothetical. Thus, it was not sufficient to show that the proceeds from the book debts were paid into a blocked account. It must be shown that the blocked account was actually operated and the proceeds were actually paid into that account.

3.5 Continuing controversy

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44 [2005] 2 AC 680.
45 *Re Spectrum Plus Ltd*, note 29 above.
Despite the clarification afforded by the decision in *Spectrum* the floating charge in England remains controversial. The distinction between fixed and floating security and the significant consequences of that distinction in terms of the commercial value of any particular charge have long thought to be part of the wider problem of the adoption of a more rational and simplified system of personal property security. The floating charge suffers from a number of defects that impairs its efficiency as a security device, so that many have argued that it has come to the end of its useful life.\(^{46}\)

Complexities include the different registration requirements and the consequences of non-registration; the low priority ranking of the floating charge on insolvency; the subordination of floating charges to the costs of liquidation; the differential and inferior treatment of floating charges as regards the date of creation of floating charges where no new consideration is given, and the prohibition of the appointment by a floating chargee of an administrative receiver.

In 2004, the UK Law Commission recommended\(^ {47}\) that the floating charge be replaced with a new type of security based on the US notice-filing system. However, by 2005, the Law Commission Final Report retreated from recommending substantial reform in the new Companies Bill due to lack of time to prepare new legislation and the limited remit the Commission had been given which did not include a comprehensive

\(^{46}\) For example Sevenoaks, *Financing Requirements in the 21st Century and the (In)Adequacy of the Floating Charge, ICCLR* 17 (2009).

\(^{47}\) Consultation Paper No. 176, Company Security Interests.
consideration that such a major reform would have on the closely associated insolvency regime. As a result, substantive reform has been shelved indefinitely. Unfortunately, a similar outcome will be replicated in Hong Kong, as the Companies Bill 2010 makes no substantive changes to the corporate security regime.\footnote{Further details may be found in the Crowther Report on Consumer Credit (Cmd 4596), para 5.7.77; see also AL Diamond, A Review of Security Interests in Personal Property, (London: HMSO, 1989).}

However, other major common law jurisdictions have jettisoned the traditional paradigm. Canada, New Zealand and now Australia have abandoned the fixed/floating charge regime in preference to a notice-filing system modelled on the United States personal property security system. Most recently the Australian Personal Property Security Act 2009 radically reshaped the whole system of granting security over all types of personal property. The notice-filing system of personal property security does not distinguish between fixed and floating security interests and so obviates all the associated complexities. Only England and Hong Kong retain the floating charge. This trend toward a notice-filing system in common law jurisdictions makes China’s adoption of the floating charge look outmoded and the choice of this complex common law device appears to be all the more surprising and anomalous.

4.1 The Credit Security System in China prior to the Property Law 2007

From 1949 to 1978, China’s economy was centrally directed under a very rigid system of state planning. As a result, security devices were not widely needed as socialism had replaced capitalism. The government drew up specific plans for enterprises and the Ministry of Finance used state-owned banks to allocate funds direct to enterprises for operational expenses or to complete specific projects. As cash distribution agents of the government, the only role played by banks was to administer funds to implement state plans. Given that banks did not have to screen projects or monitor the use of funds, the constraints on enterprises were quite soft.

Since China’s economic reform began in 1978, banks have increasingly required reformed state-owned enterprises (SOE) and the prospering non-state sector to provide reliable security for loans. China’s banking industry was expanded and modernized in the early 1980s when the government established the “Big Four” wholly state-owned banks, which took over the lending functions of the People’s Bank of China. There are three primary types of loan granted by Chinese banks: policy credits, guarantee-backed loans and secured or collateral loans, but it was not until the mid-1990s that loan guarantees and security-backed loans were widely used by banks as significant risk management tools. According to a survey of 13 major domestic banks, secured loans increased from 22% to 32% of all loans granted between 2000 and 2005.

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Prior to the promulgation of the Property Law (2007), the effective law governing security rights over property was the Security Law (1995) (hereinafter “Security Law”). Under the Security Law, three types of security interest could be granted over property, namely the pledge, the lien, and the mortgage. The definition of pledge and lien was similar to that in the common law: a pledge involved the transfer of a possessory interest in property, and included an implied power to sell. A lien was the right to retain lawful possession of the property of another until the owner fulfilled a legal duty to the person retaining the property. However, the definition of mortgage was somewhat different. The term “mortgage” under the Security Law refers to a transaction whereby a debtor or a third party (“mortgagor”) provides certain property as security for an obligation without the transfer of the title or possession of that property. If the debtor fails to fulfil his or her obligation, the creditor (“mortgagee”) has a priority interest in the property and may receive proceeds of the sale of that property. This definition is different from the common law notion of a mortgage, which requires the transfer of title. Rather, it is closer to the civil law hypothec or the common law charge.

As regards the type of asset that could be used as security, the Security Law provided that immovable property such as land use rights, buildings and machinery, and some types of

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52 1995 Security Law Chapter IV.
53 1995 Security Law Chapter V.
54 Art 33, 1995 Security Law.
movable property such as vehicles could be the subject to mortgage,\(^{56}\) whereas intangible movable property including securities and other proprietary rights could only be the subject of a pledge.\(^{57}\) Book debts (account receivables), although not specifically iterated in the Security Law, were generally considered to be included as a type of “proprietary rights that could be pledged”.\(^{58}\) However, future property was not mentioned as one of the assets capable of being subject to a pledge or mortgage in the Security Law. Needless to say, the idea of utilizing the entire assets of an enterprise, as security was not considered when the 1995 Security Law was promulgated.

4.2 The Need for More Flexible Security System: Economic and Political Considerations

China’s financial system was, until very recently, dominated by the banking sector. Economists have argued that better banks—which are more adapt at identifying creditworthy firms, mobilizing savings, pooling risks, and facilitating transactions—accelerate economic growth.\(^{59}\) Despite this, China’s banking sector is still characterized by the dominance of the “Big Four” state-owned banks which were historically used by the government to channel household savings to SOEs and conduct “policy lending”, often disregarding commercial banking principles.\(^{60}\) Consequently, state-owned banks

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\(^{56}\) Art 34 1995 Security Law
\(^{57}\) Art 75 1995 Security Law
\(^{58}\) Article 75, Security Law.
have accumulated a huge stock of non-performing loans. In theory, banks can price credit risk through interest rates. However the Chinese government maintains tight control over lending rates, which prevent them from efficiently reflecting the risk of borrowers defaulting. These circumstances translated into the need to develop lending backed by security over assets, so as to control credit risk and to improve the banks’ performance. The common law floating charge, as an established security device in England and Hong Kong, was therefore considered to be potentially useful in helping to pragmatically increase the range of security device available to banks and to allow a wider pool of assets that could be used to secure loans and thereby reduce lending risk.

On the other hand, the importation of the floating charge security device into China’s banking practice was seen as of paramount importance in assisting the development of the predominantly privately owned small and medium enterprise (SMEs) sector. In 2011, the number of SMEs in China exceeded 46 million. SMEs account for 99% of the nation’s total enterprises in number and provide over 80% of new employment. Their industrial output accounts for 60% of the national total. Increasing SME lending has become a political priority because the Big Four State banks have been traditionally

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61 Since 1996, when loans to all firms had to range between 0.9 times to 1.1 times the official benchmark rate, the government has been gradually deregulating lending interest rates. As of October 2004, there is no upper limit on interest rates, only a floor of 0.9 times the benchmark rate. However, despite the increased flexibility provided by the liberalization of interest rates in recent years, scholars observed that loan pricing remains largely undifferentiated. See Koivu, T., 2009, Has the Chinese Economy Become More Sensitive to Interest Rates? Studying Credit Demand in China, 20 China Economic Review, 455-70.


63 See China’s 11th Five Year Plan (Part 3, Section 9) “SME development should be bolstered. The construction of innovation training bases and entrepreneurial service centers should be stepped up… Emphasis should be put on supporting SMEs’ projects relating to financing guarantees, entrepreneurial guidance, independent innovation, clean production, international cooperation and personnel training while fostering commercialized SME service systems…. The construction of a SME financing service platform
reluctant to lend to the SMEs. Compared with SOEs, SMEs were predominantly in the private sector and did not have the same level of political backing as was enjoyed by the SOE sector that had close political ties as well as implicit ‘cover’ should loans sour. Consequently, SOEs had much easier access to banks and financial markets than non-state, non-listed firms. Additionally, asset-light, high-growth SMEs’ most valuable assets were often in the form of trading stock, book debts, and intellectual property rights, most of which are intangible, with low pledge-ability and a volatile market value. These circumstances have created substantial difficulties for state banks to grant credits to SMEs, as they are reluctant to accept these assets as security. Table 1 shows that there were at least 16 trillion RMB worth of assets left idle which could not be used as security due to various legal obstacles. The fact that these assets cannot be used as collateral has a significant impact on economic growth. Consequently, to expand their businesses, Chinese SMEs have to obtain credit to a large extent outside the formal banking system. Anecdotal evidence suggests that they rely on unofficial channels of finance which are formally illegal and which apply exorbitant rates of interest to any credit advanced. A typical example is Wenzhou, an economic hub in Zhejiang province, known for its successful private sector entrepreneurs. A high level of social trust and the adoption of an informal enterprise-finance system that has produced the most vibrant private sector economy in China characterized the “Wenzhou Model” of growth. The informal financing channels were illegal under Chinese regulations but tolerated by the local government as high economic growth benefitted not only the private entrepreneurs but the local population too. The local government also reaped higher tax revenues.

should be facilitated to help capable SMEs tap into the capital market for funds and construct an open financing system for them.”
However, in 2011, this model was hit by severe debt crisis. Many SMEs had become reliant on the high-interest underground lending market, as they were unable to obtain bank finance when the government tightened lending requirements to tame inflation. SME firms later discovered that they could not repay the loans due to poor economic conditions and investment losses. As a result, one-fifth of the city’s 360,000 SMEs ceased operations due to cash shortages, and nearly 100 business owners disappeared or declared bankruptcy to escape debts owed to individual creditors from the informal lending market. This created public panic. Consequently in March 2012, the State Council issued a plan to establish an experimental financing zone to test experimental financial reform in Wenzhou. The primary measure is to legitimize the underground civil debt market and place it under more effective regulation. The pilot program involves establishing 100 micro-finance firms, two to four private capital management companies, and a private financing registry to transform the city into a centre for the provision of private capital financing.64

These experimental reforms in one city may eventually lead to a much broader private financing system ultimately leading to the creation of a much larger privately-held banking sector. This may eventually help to solve the bank credit famine that has hampered private sector growth in China. A recent study on formal and informal finance in China shows that even controlled for the selection effect, firms with bank financing grow faster than similar firms without bank financing.65 Thus, the importation of an

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inchoate security device through which the assets commonly owned by SME’s could be collateralised by banks become an urgent task for the Chinese authorities if they were to achieve the goal of increasing credit flows to this fast-growing sector of the economy. The ability to expand the pool of assets capable of being monetized through a more flexible credit-security structure that would allow both present circulating asset and future property to be utilized as security would hopefully allow SME’s greater access to the formal banking sector and thereby bolster economic growth and employment.

### Table 1: At Least 16 trillion RMB Worth of Assets Left Idle Due to Legal Obstacles on Security (Unit: 1 billion RMB)

<table>
<thead>
<tr>
<th>Assets Possessed</th>
<th>All Enterprises</th>
<th>Small and Medium Enterprises</th>
<th>Rural Households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immovable Property</td>
<td>8856.7</td>
<td>4108.7</td>
<td>4209.2</td>
</tr>
<tr>
<td>Trading Stocks</td>
<td>5139.4</td>
<td>3032.6</td>
<td>1024.0</td>
</tr>
<tr>
<td>Account Receivables (Book Debts)</td>
<td>5551.9</td>
<td>3276.0</td>
<td></td>
</tr>
</tbody>
</table>

Note: Shaded area notifies the types of assets that are not utilized as security due to various legal obstacles.


4.3 The Floating Charge Rules Incorporated into the Property Law

China’s Property Law (hereinafter “Property Law”) was promulgated by the Tenth National People’s Congress on 16 March 2007, and became effective on 1 October 2007. Legal scholars who discussed and drafted the model property code focused on the provisions of the German and Swiss Civil Codes with reference to the Japanese and Taiwanese Codes as being analogous to the Chinese system as regards legal culture,
values, language and history. The Property Law took an unprecedented eight readings from 2002 to be enacted. Its passage was significant not only because the law has, for the first time, asserted equal legal protection of public and private property, but also because it has created a unified regulatory framework for civil relationships arising from the attribution and utilization of property, including the creation, realization and enforcement of all types of security over property. This law, together with China’s revised Contract Law (1999), revised Marriage Law (2005), and Tort Law (2009), were seen as significant steps toward the completion of a unified Civil Code to replace China’s General Principles of Civil Law, which has been in force since 1986.

The floating charge provisions were first added to the proposed law in its third draft, and finally embodied in three articles of the Property Law, namely Articles 181, 189 and 196. Article 181 regulates the creation and effect of floating charge, Article 189 specifies the registration requirements and the effect of non-registration, and Article 196 regulates...

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67 Art 4 Property Law.
68 Art 2 Property Law.
69 It should be noted that enactment of the Property Law does not repeal the 1995 Security Law, though there is substantial overlap between the two. The reason is that the 1995 Security Law covers not only security over property but also security on debts such as personal guarantee and deposits, which are not covered by the 2007 Property Law. As for the issue of precedence between the two laws, Art. 178 of Property Law made it clear that in case of any conflict between the rules in the Property Law and Security Law, the Property Law rules shall prevail.
70 Article 181 of Property Law reads: “Upon the written agreement between the parties concerned, an enterprise, individual industrial and commercial household or agricultural production operator may mortgage the manufacturing facilities, raw materials, semi-manufactured goods and products it has already owned or is going to own, and when the mortgagor fails to pay its/his due debts or any circumstance for realizing the right to mortgage as stipulated by the parties concerned occurs, the mortgagee shall be entitled to seek preferred payments from the chattels that exist when the parties concerned stipulate to realize the right to mortgage. (Original text in Chinese, translated by the author)
71 Article 189 of Property Law reads: “In case an enterprise, individual industrial and commercial household or agricultural production operator mortgages any of the chattels prescribed in Article 181 of this Law, it shall file registration with the administrative department for industry and commerce at the place where the mortgagor resides. The right to mortgage shall come into effect as of the effectiveness of the...
the crystallization of floating charges created pursuant to Article 181. Significantly, these three articles are all placed within the chapter entitled “Mortgage” in the Property Law, with the implication that the Property Law does not treat the floating charge as creating a distinct type of security device, but rather viewing it as an extension of the existing mortgage regime.

In order to provide a comprehensive comparison between the floating charge rules in the Property Law and their counterpart in English law, we divide our analysis into six sections. Namely, who can create a floating charge; which assets are capable of being charged and how they are controlled; issues of formality and validity; crystallization; realization and enforcement, and priority issues. These six issues take into account the characteristics of the floating charge and specific differences in the respective rules. This process is adopted from Djankov, McLiesh and Shleifer (2007), who developed a list of functional criteria to determine the degree to which a country’s collateral and bankruptcy laws facilitate borrowing. In analysing each aspect, we follow standard legal research

mortgage contract; without the registration, the right to mortgage shall not challenge any bone fide third party.” (Original text in Chinese, translated by the author)

72 Article 196 of Property Law reads: “With respect to the mortgage established according to Article 181 of this Law, the property under mortgage shall be determined when any of the following circumstances occurs:
(1) The mortgagee’s rights have not been fulfilled upon expiration of the time limit for paying debts; (2) The mortgagor has been declared bankrupt or has been revoked; (3) Any circumstance for realizing the right to mortgage as stipulated by the parties concerned occurs; or (4) Any other circumstance that will seriously affect the realization of mortgagee’s rights.” (Original text in Chinese, translated by the author)

73 These criteria are: (1) whether general—rather than specific—description of assets is permitted in collateral agreements; (2) whether general—rather than specific—description of debt is permitted in collateral agreements; (3) whether any legal or natural person may grant or take security; (4) whether a unified registry including charges over movable property operates; (5) whether security provides priority outside of bankruptcy; (6) whether parties may agree on enforcement procedures by contract; (7) whether creditors may both seize and sell collateral out of court. See Simon Djankov, Caralee McLiesh, and Andrei Shleifer, 2007, Private Credit in 129 Countries, Journal of Financial Economics 84(2), 299-329.
methodologies\textsuperscript{74} to consider relevant legal sources pertaining to the floating charge in China, with particular attention being paid to the legislative history and to the documents that facilitate our understanding of the final form of the Chinese floating charge rules. Finally, we emphasise that the implementation and enforcement of law in China poses particular difficulties and our research findings, where applicable, were cross-referenced through interviews with Chinese bankers who are familiar with the granting of such security, and who had access to banks’ internal operational guidelines on the granting of credit facilities on this basis.

4.3.1 Who can create a floating charge in China?

Legal systems differ on the eligibility requirements for creating floating charges or their analogues. In England, only companies can create a floating charge, whilst individuals and partnerships cannot.\textsuperscript{75} In Japan, the criteria are even stricter: only publicly listed companies are entitled to create such a security and the charge can only be granted over the entire assets of the company.\textsuperscript{76} In contrast, the U.S. legal system does not impose any restrictions on who may create an inchoate security interest,\textsuperscript{77} so that companies, partnerships, sole-proprietorships, or individuals are all entitled to create such security interests over their assets.

\textsuperscript{74} See, for example: Mike McConville and Wing Hong Chui (Eds.) Research Methods for Law (United Kingdom: Edinburgh University Press, 2007).


\textsuperscript{77} For relevant provisions on floating charge under the US law, see Article 9-204 of the Uniform Commercial Code (UCC).
China appears to have been influenced by the permissive U.S. model. According to Article 181 of Property Law, all “enterprises, individual industrial and commercial households or agricultural production operators” are able to create a floating charge. The term “enterprise” in China is a generic word equivalent to “business organization” which includes limited liability companies, partnerships, and sole-proprietorships. The term “individual industrial and commercial households” refers to those individuals or families who use their individual or family assets to undertake business with unlimited liability. The term “agricultural production operators” refers to members of a rural collective economic organizations who engage in farming under a contract and have unlimited liability. Thus, the number of business actors able to create a floating security under Chinese law is much greater than under English law and is more comparable to the position in the United States. As suggested by some Chinese commentators, underlying this policy choice was the legislative intent that the floating charge should assist the expansion of financing options of SMEs and also the facilitation of rural finance, to assist in reducing the wealth gap between rural and urban areas. Promoting the growth of credit on security via formal banking channels helps to legitimize SME credit arrangements and also lowers the cost of credit to such businesses, thus aiding their expansion.

However, the intention of the government to extend financing channels, by making the floating charge device available to all businesses, may not be realized. Professor Liang Huixing of Chinese Academy of Social Sciences, a prominent jurist and a draftsman of the Property Law shared this concern. In his published commentary on the various drafts

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79 Article 27, ibid.
of the Property Law, Professor Liang warns, “the functioning of floating charge security device requires a high level of credit worthiness on the part of the borrower. The reason the Japanese law only allows public companies issuing bonds to grant floating security is that these companies are more creditworthy in terms of financial capacity and have higher disclosure requirements than private companies. Only the strongest listed companies are allowed to issue corporate bonds. Thus, creditors’ rights are better protected when the privilege of creating floating security is only available to such companies”80.

Compared with developed nations, China lacks a reliable credit referencing system.81 There is no personal bankruptcy law in China; databases on consumer credit, enterprise credit and government credit are rudimentary and problematic. Credit rating services in China are still in their infancy. Sole-proprietors and rural agricultural operators tend to have low accountability and a limited credit history. Compared with SOEs and publicly listed firms, SMEs often require small loans but each renewal review of the credit line by the bank is a substantive one, so increasing costs and causing delay. In case of default or if the borrower absconds with the tangible charged assets, banks have great difficulty in taking control of the collateral. These problems translate into high transaction costs for banks when dealing with SMEs. To alleviate such risks, banks often require additional security such as third-party guarantees, but this modality inhibits the economic efficiency

80 Cited from Prof. Liang Huixing’s public speech at Renmin University on November 24, 2006, titled “Comments on the sixth draft of the Property Law”, available at: http://article.chinalawinfo.com/Article_Detail.asp?ArticleId=35989 (Last accessed on April 2, 2012)
purpose served by the introduction of the floating charge security device. Interviews with bankers in China support the proposition that commercial banks favour large over small borrowers, industrial over agricultural businesses, and standardized over specialized security. According to a lending officer in a municipal-level commercial bank: “The risk-adjusted return for lending to small and/or agricultural businesses is simply too low to attract us to offer credit lines.”  

In practice, SMEs and rural agricultural operators still, to a large extent, rely on policy loans, as opposed to commercial loans, if they wish to access the formal banking sector.

4.3.2 Assets capable of being charged and their control

In England, Re Yorkshire Woolcombers Association confirmed that a floating charge could be created over a class of assets, present and future. Two inherent characteristics of such assets are that the pool of assets will fluctuate as part of the normal course of business, that both parties to the charge expect that the company’s ordinary business will continue indefinitely and that alienation of charged assets will proceed without the necessity to seek the chargee’s permission for such transactions. Thus, book debts, trading stock, and other fluctuating assets can all be subject to a floating charge. Often in England, a floating charge is created over all the present and future assets including the whole undertaking of the company. The rationale being that the security value of the

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82 For reasons of confidentiality the name of the bank is not disclosed. The interviewee is in charge of the micro-credit division in this municipal-level commercial bank.
83 Re Yorkshire Woolcombers Association [1903] 2 Ch 295
84 See also Lord Scott in National Westminster Bank v Spectrum [2005] UKHL 41: “The essential characteristic of a floating charge…is that the asset subject to the charge is not finally appropriated as security for payment of the debt until the occurrence of some future event. In the meantime, the chargor is left free to use the charged asset and to remove it from security.”
entire business will be greater than the aggregate value of the company’s component assets.

Article 181 of Property Law does, for the first time, allow mortgages, similar to the common law floating charge, to include future assets. Unfortunately, the assets that can be appropriated to a floating security are much more limited in scope than in English law. Assets that can be so charged are confined to “present or future manufacturing facilities, raw materials, semi-manufactured goods and products”. From the legal text, it is possible to conclude that trading stock can now be subject to a floating charge to the extent it constitutes the types of asset mentioned above. However, this range of assets remains extremely limited: immovable property such as land-use right and premises are excluded and can only be secured by a traditional mortgage, the equivalent of a fixed charge. Most intangible assets such as book debts and intellectual property rights can only be offered as security by way of a pledge under Chinese law.85 To understand why such a narrow scope of asset has been available as collateral for a floating charge, it is necessary to discover the original legislative intention of the Chinese legislator. According to Professor Wang, that intention was to develop the concept of the “collective mortgage”86 that was already available to companies under the Security Law. He considers that the legislators viewed the “collective mortgage as more efficient as it

85 Article 223 of Property Law reads: The following rights may be pledged by a debtor or third party: [……] (5) Exclusive trademark rights, patent rights, copyrights or other property rights in intellectual property that can be transferred;(6) book debts; and (7) Other property rights that can be pledged according to any law or administrative regulation.

86 The collective mortgage allows the company in question to create a mortgage over various assets of a company. However, unlike the floating charge, which can secure after-acquired and substituted movable property, the identity of the mortgaged property under a collective mortgage must be certain before a mortgage contract is concluded. See Article 39 of Security Law. Besides, the concept of crystallization, a crucial mechanism to convert the floating charge into a fixed security, is unknown to the collective mortgage.
increased the value of assets available as security, and represented a logical
development of available security structures.” 87 However, he continued, “the drafters of
the Property Law decided to limit the scope of assets available for appropriation to a
floating charge to movable property, on the basis that, historically, most enterprises’
immovable property had already been mortgaged. Therefore, making such property as
security for a floating charge might create conflict between old mortgagees and new
chargees”. 88

This appears to be a concern about priorities rather than a doctrinal dispute over the
assets that should be available as security for a floating charge. The legislators appear to
have had a pragmatic concern about reducing future disputes, rather than being a choice
based on defensible criteria for example as to the suitability of an asset class to be
subject to this type of security device. Given that the Chinese mortgage, as well as the
pledge over proprietary rights, both share a certain common characteristics with the
common law charge, we will attempt to provide a discussion, in the next section, of the
extent to which each asset class can be offered as security and we will focus on the
crucial issue of control of the charged asset as an essential component of secured bank
lending.

Assets amenable to floating security and control

Article 180 of Property law specifies the types of asset that can be subject to a mortgage.

Land-use right, premises, vessels or aircraft under construction, manufacturing facilities,

87 See Wang Liming’s speech at Renming University on the Civil and Commercial Law, available at:
88 Ibid.
raw materials, semi-manufactured goods and products fall into this category.\textsuperscript{89} The creation of a mortgage requires a written mortgage contract between the mortgagor and mortgagee, and the registration of the mortgage at the competent agency. After the mortgage is granted, the mortgagor can continue to utilize the mortgaged asset but any transfer of the asset requires the mortgagee’s approval, and even when such approval is given, the proceeds of the sale of the specified asset must be used to repay the mortgaged debt or the proceeds must be deposited with a competent body.\textsuperscript{90} If the mortgagor fails to fulfil the obligation to repay the mortgaged debt, the mortgagee has a priority interest in the property and may receive proceeds from the sale of the charged property.\textsuperscript{91} These characteristics of the Chinese mortgage resemble those of the common law fixed charge in practice.

To discover the extent to which each type of asset is actually accepted by banks as security in practice, we obtained several Chinese banks’ \textit{internal guidelines} on the types of asset that they will accept as collateral. The guidance regards that some asset classes are automatically acceptable, whilst others are restricted or prohibited. The guidance also stipulates maximum loan to value ratios (LTV). An example of such an internal guideline is shown in Table 2.\textsuperscript{92} Residential premises, commercial buildings and land-use rights are among the most common assets accepted as security. This asset class is universally accepted by the banks collateral and with LTVs of up to 70\% of the value of residential

\textsuperscript{89} Certain exclusion of mortgage-able asset is provided under Article 184 of Property Law.
\textsuperscript{90} Article 191 of Property Law.
\textsuperscript{91} Article 195 of Property Law.
\textsuperscript{92} For confidentiality reasons we have omitted the name of the bank. All the items listed are allowed by the Property Law to be offered as security. Different banks may have varying guidelines on the types of asset that are allowed / restricted / prohibited to be accepted as security, and the maximum ratio of the loan that can be granted based on the security’s valuation may also vary among banks.
premises, 60% of commercial or residential land-use rights, and 50% of the value of warehouse or factory premises. Interestingly, vessels and aircraft are not acceptable assets to many banks. Vehicles and machinery are among the “restricted” class, which means that there is quota of such assets the bank will accept in aggregate as security. Moreover, manufacturing facilities, raw materials, semi-manufactured goods and products are not specifically itemized, however a class of assets labeled “other movable property which can be mortgaged under the law”, is included but is characterized as “unacceptable” as security to this particular bank. This appears to show that whilst, in principle, certain types of asset are capable of being used as security, in practice Chinese banks are reluctant to accept them.

Table 2: An Internal List and Standard of Permissible Security from a Bank

<table>
<thead>
<tr>
<th>Type of property that can be mortgaged or pledged under the Property Law</th>
<th>Standard loan to value ratio</th>
<th>Whether this security is “Acceptable / Restricted / Unacceptable” by the bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential property</td>
<td>70%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Office premises</td>
<td>60%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Shops and shopping centers</td>
<td>60%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Hotels</td>
<td>50%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Factory premises</td>
<td>50%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Warehouses</td>
<td>50%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Land use rights of residential and commercial properties</td>
<td>60%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Land use rights of industrial property</td>
<td>50%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Car parks</td>
<td>50%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Multi-purpose land use rights</td>
<td>50%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Other land use rights</td>
<td>40%</td>
<td>Restricted</td>
</tr>
<tr>
<td>On-going construction projects</td>
<td>50%*</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Aircrafts</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Vessels and ships</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Cars and other vehicles</td>
<td>50%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Machineries</td>
<td>40%**</td>
<td>Restricted</td>
</tr>
<tr>
<td>Other movable properties permitted by law</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Shares of listed companies</td>
<td>60%</td>
<td>Restricted</td>
</tr>
</tbody>
</table>

93 According to the bank’s internal guideline, “unacceptable” mortgage means such mortgage cannot be approved by any branch or subsidiary of the bank, but needs to be evaluated on a case-by-case basis by the chief risk management officer in the headquarter bank, subject to supplementary requirements.
<table>
<thead>
<tr>
<th>Shares of unlisted companies (only for nation-wide financial institutions)</th>
<th>50%</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade marks</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Patents</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Copyrights</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Right to collect tolls (only for first-class highway)</td>
<td>65%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Right to collect electricity fees</td>
<td>65%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Right to collect education tuition fees</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Other rights to collect revenue from immovable property</td>
<td>NA</td>
<td>Unacceptable</td>
</tr>
<tr>
<td>Book debts</td>
<td>80%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Standard warehouse receipt</td>
<td>70%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Bills of lading</td>
<td>70%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Export rebate account</td>
<td>95%</td>
<td>Acceptable</td>
</tr>
<tr>
<td>Mining rights</td>
<td>70%</td>
<td>Restricted</td>
</tr>
<tr>
<td>Export insurance policy</td>
<td>90%</td>
<td>Acceptable</td>
</tr>
</tbody>
</table>

Note: For reasons of confidentiality, we omitted the name of the bank. “NA” means this property is not acceptable by the bank as security, or even if acceptable, the loan to value (LTV) for mortgage/pledge needs to be reviewed on a case-by-case basis. “Acceptable” means this property is fully acceptable by the bank as eligible security with no quota constraints. “Restricted” means this property can be acceptable by the bank as eligible security, but the banks has quota of such asset to be used as security. “Unacceptable” means this property, although allowed by the law to be used as security, is not acceptable by the bank as eligible security.

* Only limited to the mortgage of on-going construction project for providing capital to continue to develop the on-going construction.

** Mortgage-able machinery is limited to those constitute the core assets of the debtor, with stable technology, stable price record, and a strong second hand market, and easily realizable. Machinery not meeting this requirement is unacceptable to the bank as eligible security.

Notwithstanding, that credit policies differ between banks, and that our investigations identify a few aggressive banks that offer floating-charge-like mortgages pursuant to Article 181 of Property Law, many banks remain reluctant to accept such a security. We examined a standard floating charge debenture from a private sector bank, together with the internal guidance to credit officers as to how such a security should be considered. We found that a standard debenture provides revolving credit facilities with a specific maximum credit line in consideration for the charge. The secured assets include manufacturing facilities, raw materials, semi-manufactured goods and products. Further, the parties agree that the future assets of the company in the same classes will be automatically subject to the charge; during a period the credit facility remains open. The chargor retains possession of the charged assets, and is able to use, profit from, and
dispose of them without chargee’s specific approval. However, the disposal of charged asset cannot be “unusual” and must conform to the chargor’s ordinary course of business; disposal in breach of this stipulation are invalid and trigger the crystallization of the charge. Moreover, before granting the loan, the chargee may require the chargor to obtain insurance cover in respect of the charged asset and assign the benefit of the policy to the bank. From this standard contract, we conclude that the Chinese conception of the security device conforms in many respects to the practises adopted in respect of common law floating charges except that the range of assets accepted as collateral is very narrow.

Given the limited scope of assets that can be subject to the charge, it is not surprising that, even though the device exists in practice, it is not the preferred security mechanism. This proposition finds support from the internal operational guidance provided to credit officers, where it is made clear that security over manufacturing facilities, raw materials, semi-manufactured goods and products to be created should be by way of a pledge rather than by way of a floating charge. On enquiry, the primary reason given by the bank for this preference is that the pledge requires transfer of possession of the asset from the pledgor to the pledgee or its designated third party, so that the bank exercises more actual control of the asset. A second reason advanced was that there remained uncertainty in Chinese law as to the priority accorded as between a pledge and a mortgage over the same property. Due to its possessory character, the pledge is considered to provide a superior claim to that of a non-possessory mortgage. As previously noted, the Property Law designates the floating charge as a special type of mortgage. However, it appears
that banks would prefer that this security be classified as a type of pledge so as to benefit from a stronger security claim in the case of default.

Where a borrower prefers to create a mortgage (rather than pledge) pursuant to Article 181, the bank’s internal guidelines require credit officers to “conduct field investigations, design an operational plan, and designate a custody warehouse,” often from a list of the bank’s certified warehouses. This effectively means, in most cases, that the debtor will no longer have possession of the charged asset, once the security device is executed as in addition to the creation of the floating charge, the bank will require a tripartite custody agreement be executed by the debtor, the bank, and a custody service operator, whereby specified physical assets are transferred to the custody of a certified warehouse and held to the banks order in pursuance of the covenants in the debenture. This additional requirement thus negates the primary purpose of a non-possessory floating charge security and demonstrates the desire of lenders to exercise maximum physical control over collateral assets.

Provisions in such agreements require a “threshold of minimum value”. The implication is that where, for example, a minimum value threshold is set at 20%, then the chargor can only unilaterally remove from custody secured assets worth up to 80% of a specified value without obtaining the bank’s specific consent. The custody agreement provisions, coupled with this minimum value threshold requirement, is intriguing, as it demonstrates in practice, that even if a bank accepts a floating charge, the chargor does not have freedom to deal with the charged assets in the ordinary course of business. However,
banks do recognize the need for the charged assets to circulate in ordinary course of business, and that specific approval for each and every dealing with the charged assets would not only paralyze the debtor’s business, but would also be impractical. However, banks remain hesitant to allow absolute freedom for the debtor to deal with the secured assets and prefer to interpose the custody service operator as a ‘gatekeeper’ to further protect its interests. This tripartite arrangement, adds considerably to transaction costs and operational complexity, though it does allow some of the benefits of the floating charge to be achieved in the complex operational context of China, where fraud is a constant background issue in many commercial transactions, so explaining banks’ weariness in trusting their customers.

*Assets amenable to Pledge and Control*

Given the de jure and de facto limitations on the floating charge in China, it is necessary to review briefly the pledge system for granting security under Chinese law. Chinese legislation adopts the Roman law concept of *pignus* and both the Security Law and the Property Law distinguish between two types of pledge, namely a pledge over movable property and a pledge over proprietary rights. A pledge over movable property involves the transfer of possession of the property from the pledgor to pledgee, and the pledgee has an implied power to sell the pledged property in his possession in case of default. In contrast, the concept of a pledge over proprietary rights often creates difficulties, as certain proprietary rights, such as those constituted as intellectual property rights or book

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94 This distinction under Chinese law is itself problematic and subject to criticism.
debts, cannot be the subject of a physical transfer of possession.\(^{96}\) To overcome this difficulty the law provides that where proprietary rights are pledged, the parties must enter into a written contract of pledge and such a pledge will not become effective against a third party unless it is registered with the competent authority.\(^{97}\) This requirement makes a pledge over proprietary rights similar to a mortgage in practice. The unclear boundary when a mortgage or pledge over proprietary rights has been subject of a great deal of criticism and debate, especially where priority issues are involved.\(^{98}\)

Given that a pledge over proprietary rights in China exhibits certain characteristics of the common law charge, the key comparison is to consider the vexed issue of control over the secured property. Two classes of proprietary right are of particular interest to business, namely intellectual property rights and book debts.

**Pledge of intellectual property rights**

In China the intellectual property (IP) rights mainly consists of proprietary rights over trademarks, patents, and the commercial component of copyrights. Article 227 of Property Law provides:

>“Where the property rights in the intellectual property have been pledged, the pledgor shall not transfer the pledged property or permit anyone else to use it without the approval of the pledgee. Furthermore, any proceeds from the sale or

\(^{96}\) Though in theory, documents of title such as copyright / patent / trademark certificates can be physically transferred possession into the hands of pledgee, but it has no practical use and the pledge cannot prevent the pledgor from exploiting such rights in the ordinary course of business. Nevertheless, in practice Chinese banks generally require the physical delivery of the original title certificates.


licensing of pledged intellectual property rights shall be applied first to repay the pledge or be deposited at a competent body.”

From Article 227 it can be reasonably anticipated that after the grant of a pledge the pledgor is still able to exploit IP rights for its own use, however, any assignment or licensing of such rights must be with the pledgee’s approval. Even with such approval, the proceeds of an assignment or license cannot be utilized by the company as working capital, but must be handed to the pledgee in full or partial satisfaction of the pledge. It follows, that the pledge of IPRs in China differs in this essential characteristic of an English floating charge, but instead finds more closely corresponds to the requirement of a fixed charge. This proposition finds support from a Chinese banker who told us: “we actually encourage the pledgor to utilize its own IP rights in the ordinary course of business because IP rights, if not used, have no value. However, we have to control the revenue obtained if the pledgor wishes to transfer or license its IP rights”. In banking practice, the pledge of IP rights requires the physical transfer of possession of the original title certificate, and the execution of a written contract in which the pledgor undertakes not to transfer, license, or create any other security interests over its IP rights during the period of the pledge. Registration of such a pledge with Trade Mark / Copyright / Patent Office is also an absolute requirement.

Chinese bankers also consider that although IP rights can be pledged in law, in practice due to the uncertainty of their value, most banks are reluctant to accept IP rights as security. An interviewee bluntly told us: “We are often unable to understand the true
value of an IP right as I think more than 95% of Chinese domestic patents are rubbish and with no security-lending value”. 99 If this sentiment is widespread, then SME’s innovators who create registrable IP rights will continue to encounter extreme difficulty in obtaining credit for use as working capital based on the value of their intellectual property assets. Chinese bankers’ attitudes toward domestically created IP rights and their problematic valuation is the issue here, rather than a conceptual legal difficulty in utilizing such assets as security.

Pledge of book debts

Other than IP rights, a pledge over book debts in China is also a vexed topic. Article 228 of Property Law provides that

“Rights in respect of pledged receivables cannot be transferred to third parties without the approval of the pledgee. Even where approval is given, the proceeds arising from such transfer must be applied to repay the debt, or be deposited with the competent authority”.

Thus it is clear that the right to collect receivables cannot be assigned to third parties without the pledgee’s consent. However, the law is silent on whether the pledgor is able to use the receivables in its ordinary course of business. Without the ability to use receivables as working capital, the utility of the pledge as a financing tool is significantly restricted and if specific consent is required to utilize the proceeds of a pledged debt, the issue of impracticality becomes crucial in a similar way to the English requirement as regards fixed charges.

99 Supra note 82.
Our interview with bankers in China reveals, surprisingly, that the usual practice of Chinese banks is to only deal with book debts by way of factoring ("baoli") instead of pledge. Factoring in law differs from a secured credit in that it is the *sale* of receivables by the business to the bank at discount. Once purchased, the book debt becomes the bank’s property and bank as a nonrecourse factor assumes the risk that a purchased account will not be collectable primarily due to the inability of the debtor to pay. Conversely, where the bank grants a loan, the book debt acts as a mere security for payment and bank is concerned with the borrower’s credit worthiness, rather than its customers. In the United States, if the factor does not assume credit risk on the purchased accounts, in most cases a court will re-characterize the transaction as a secured loan.

We obtained a copy of the internal guideline on factoring from a Chinese bank source. Chinese banks provide two types of factoring services: Non-recourse factoring and recourse factoring. The former is a “true sale” of the clients’ receivables to the bank usually at a minimum discount of 20 percent of the value of invoice, and the bank then assumes the “credit risk”. In recourse factoring, the factor will be able to reclaim any deficiency due to non-payment by the debtor from the assignor.\(^{100}\) In either type of factoring agreement, the client can choose to sell a single debt or a bundle of present and future obligations. In single debt factoring, the quantum of each advance is approved based on the particulars of the receivable. In contrast, if the client sells its entire stock of book debts, or all the debts due from a specific customer to the bank, the transaction is

\(^{100}\) In practice the seller is required to either provide guarantee or undertake to buy-back the receivables from the factor in case of non-payment by the customer.
labelled as “pool” factoring. Banks will only engage in a pool factoring arrangement where the client is of sufficient size and financial stature\textsuperscript{101} and evidence exists that the client and its customers have a “\textit{long-term, stable and continuing business relationship}”. On the question of whether the client retains control of the receivables, the agreement provides that so long as a minimum credit balance is maintained in the client’s factoring account with the bank, the client is able to withdraw cash from that factoring account, so allowing it to use some of the proceeds of the collected debts in the ordinary course of its business. However, such withdrawals do require specific approval from the bank and are subject to maximum limits as set out in the factoring agreement. This provision is significant in that it shows banks understand that book debts constitute an important source of working capital and that if such capital can be utilized by businesses, it greatly facilitates their operations and ultimately expansion. As a result, Chinese banks have developed an “\textit{approval + bottom-line balance control}” mechanism to balance the firm’s need for flexible financing arrangements with the bank’s desire to control its exposure to risk. Consequently, functionally these arrangements resemble the common law fixed charge over book debt.

4.3.3 Formality and Validity Issues

The formalities of creating a floating charge under the Property Law are set out in Articles 181 and 189 of the Property Law. First, the parties need to execute a written debenture and the debenture becomes effective on the date of execution. However, in

\textsuperscript{101} For example, our interviewed bank requires the seller’s business to have a minimum turnover of RMB 200 million if it is manufacturing based, or a minimum turnover of RMB 400 million if it is trading-based, to qualify for pool factoring service.
order for the charge to be effective as against a third party, it needs to be registered at the State Administration of Industry and Commerce ("SAIC") at the place where the chargor resides or the company is registered. An unregistered floating charge is void against other creditors and a liquidator.

A distinctive feature of the registration of security interests under Chinese law is that each class of secured asset must be registered with its corresponding registration agency. Table 3 shows the complexity of the registration requirements based on the categorization of the assets. Consequently, multiple registration requirements apply. This is especially a problematic respect of movable property and translates into high transactions cost in practice. Each registration agency has its own registration formalities and there is little consistency between the requirements. Moreover, since a nation-wide, internet-based registration system does not exist, substantial difficulties arise for creditors who wish to check the status of property offered as security for a credit advance. Most registration agencies tend to adopt a substantive rather than procedural review of the registration, and although the registration fees are nominal, the related costs of employing professional lawyers, evaluators, and a notary in order to complete the registration can substantially inflate the transaction costs. A World Bank-People’s Bank of China joint survey shows that over 70% of borrowers complain that high registration expenses constitute a serious problem in China’s credit security system and the complexity of the system may also lead to corruption.

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102 Substantial review means the applicant shall submit all necessary documents such as title deed, valuation report, and the security document to the authority. The authority will verify the details internally.

If an application is accepted, a record will be made at the relevant registry maintained by the affordable authority and the original document creating the security will be filed. A certificate is then issued to the mortgagee evidencing the security interest.

Table 3 Registration Authorities for Mortgage-able and Pledge-able Assets in China

<table>
<thead>
<tr>
<th>Asset Mortgage-able or Pledge-able</th>
<th>Registration Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urban land-use right</td>
<td>Municipal Bureau of State Land and Resources</td>
</tr>
<tr>
<td>Urban real estate, township enterprises</td>
<td>Real Estate Administration Bureau</td>
</tr>
<tr>
<td>Equipment, raw material, products and merchants</td>
<td>Administration of Industry and Commerce</td>
</tr>
<tr>
<td>Non-agricultural vehicles</td>
<td>Administration Bureau of Vehicles</td>
</tr>
<tr>
<td>Machinery and equipment for agriculture</td>
<td>Agricultural Machinery Station</td>
</tr>
<tr>
<td>Crops and other agricultural products</td>
<td>Bureau of Agriculture</td>
</tr>
<tr>
<td>Orchard, plantations</td>
<td>Forestry Administration</td>
</tr>
<tr>
<td>Most ships and other vessels</td>
<td>Bureau of Maritime Affairs</td>
</tr>
<tr>
<td>Fishing vessels</td>
<td>Administration of Fishery Administrative</td>
</tr>
<tr>
<td>Civil aircraft</td>
<td>Ministry of Civil Aviation</td>
</tr>
<tr>
<td>Shares of public companies</td>
<td>Central Security Registration and Settlement Company</td>
</tr>
<tr>
<td>Patents, copyrights and trademark rights</td>
<td>Patent Offices, Copyright Offices, Trademark Offices</td>
</tr>
<tr>
<td>Trust accounts for export tax refunds</td>
<td>State Administration of Taxation</td>
</tr>
<tr>
<td>Highway bridges, tunnels, ferry and toll right</td>
<td>Bureau of communications</td>
</tr>
<tr>
<td>Tuition and accommodation fee for colleges and universities</td>
<td>Bureau of Education</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Credit Investigation Centre of the People’s Bank of China</td>
</tr>
<tr>
<td>Others</td>
<td>Notary Offices</td>
</tr>
</tbody>
</table>

* Summarized by the authors pursuant to the relevant laws.

In normal circumstances when a security is properly registered it is valid and effective as against any third party. However, in England and Hong Kong, the commercial utility of floating charges is significantly undermined by legislative intervention that invalidates such charges created within certain periods of time prior to the commencement of insolvency proceedings. The rationale of these provisions is to prevent the company

104 See for example, s.245 of UK Insolvency Act 1986, supra note 37; Also see 11 U.S.C. § 548(a)(1)(B) (providing the power of the bankruptcy trustee to avoid constructive fraudulent transfers within two years prior to bankruptcy if the debtor was financially stressed at the time of the transfer and the debtor did not receive “reasonably equivalent value” in exchange.) In Hong Kong, s. 267 of the Companies Ordinance.
from giving unfair preference to certain creditors by granting to them security which would rank in priority to other unsecured creditors, while at the same time protecting the interests of secured creditors who *bona fide* lent money to the company within the prescribed period.

Under the Property Law there is no corresponding provision that invalidates a registered security (including floating charge). However, similar rule is found in the Enterprise Bankruptcy Law promulgated in 2006 (hereinafter EBL). Article 31 of EBL provides that certain dispositions of the debtor’s assets within 1 year before the insolvency proceedings commence may be set aside by the People’s Court. These include transferring assets at no consideration; assets sale at an unreasonably low price; providing security to those creditors who previously enjoyed no security; repaying creditors early without objective justification; renouncing creditor’s rights against other property.\(^{105}\)

We sought to discover how banks mitigate the risks that otherwise would undermine their security by interviewing credit officers. The answers we obtained were that insolvency risk is one that no bank can avoid *ex ante*; instead, the banks can only closely monitor their client’s financial status and/or changes in their business circumstances. For example, in a standard floating charge debenture provided by a bank, we found a provision requiring the debtor to notify the bank at least 30 days *before* the commencement of the

\(^{105}\) Art 31, Enterprise Bankruptcy Law,
following business activities - sub-contracting, leasing of property, sending assets into custody, asset restructuring, conversion from a private to a public company entering into joint ventures, mergers and acquisitions, undertaking share splits, reductions of capital, applying to suspend business activities, dissolution, compromise or bankruptcy. In the event of this stipulation being triggered, additional collateral was to be provided.

We were also interested to discover how Chinese banks deal with the problem of competing security interests over the same property, which is often a vexed issue at common law. Surprisingly, we discovered that this is not an issue of great concern to Chinese banks. The reason appears to be that the security registration system in China is relatively straightforward. The law does not distinguish between legal and equitable interest, and it only recognizes the registration date, instead of the date of creation of a security, when determining the priority of competing security interests over the same property. Most bankers informed us that to avoid this risk the best method is only accept un-encumbered assets as security. This proposition is well elaborated in a provision from an internal banking guidance that we obtained: “Every pledged / mortgaged asset must fulfill valid registration requirement, in principle our bank shall rank first in the registration document and has a priority claim over others. We will not consider secondary or lower ranking in registration unless the residue value after the claim of the prior creditor, is still sufficient to cover the principal and interest due to our bank”.

4.3.4 Crystallization
The very nature of floating charge determines that the assets appropriated to the charge will not become ascertained unless a statutory or contractual event occurs, which “crystallizes” the charge. After the crystallization, the floating charge becomes an equitable fixed charge. In China, the relevant provisions on crystallization are contained in Article 196 of the Property Law, which provides for crystallization of the charge when the debtor defaults, the chargor is declared bankrupt, any contractual crystallization event occurs, and any other circumstance that will seriously affect the realization of the creditor’s rights. According to Jiang Ping (2007), the “other circumstances” under Article 196 (4) is a reservation clause and probably refers to the circumstances mentioned in Article 31 of the EBL described above. In practice, a major disadvantage of the floating charge is that often until the company fails and the floating charge crystallizes, the debenture holder cannot be certain of the value of the assets subject to the charge. When it becomes fixed, the debenture holder may find that the value of the assets is substantially lower than anticipated. To offset this risk, parties to the charge may specify certain crystallization events in their debenture such as the debtor’s borrowing exceeds certain limits, or where the chargor creates a subsequent security over the same property—an automatic crystallization clause, or when the chargee has given written notice to crystallize the charge—a semi-automatic crystallization clause. 

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106 See *Andrekson v. Peerless Pipe and Equipment* (1982), 139 DLR(3d) 556
107 Article 196 (1) of Property Law
108 Article 196 (2), ibid.
109 Article 196 (3), ibid.
110 Article 196 (4), ibid.
111 See Jiang Ping (Eds) 中华人民共和国物权法精解 [*Interpretation on the Property Law of PRC*] (Chinese University of Law and Politics Press, 2007), at 257.
These contractual agreements between the parties thus constitute the statutory crystallization events under Chinese law.

In addition to the above, a standard floating charge debenture from a Chinese bank includes a specific power to allow the bank to enter the client’s premises and to audit the status of the charges assets. Where the value of the assets found is reduced below certain preset limits, the bank can require the client to provide additional assets to make up the deficiency and if this is not done with a specified time, the charge will be crystallized and the client’s accounts blocked.

4.3.5 Realization and Enforcement
The realization and enforcement process refers to the procedure whereby the floating charge holder discharges the debt out of the income or the proceeds of sale of the charged assets. The key issue in China is how to ensure that the floating charge holder can effectively take control of the charged assets immediately after crystallization. A related issue is how to ensure that the management’s power to deal with the charged assets terminates and no activities detrimental to the interests of charge holder can be undertaken after crystallization.

Common law jurisdictions have long recognized these risks and so the equity courts to address these issues created the office of a “receiver”. The power to appoint receiver is implied in any legal charge or equitable mortgage by deed and it is one of the remedies

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112 Re Bright Life Ltd. [1987] Ch 200.
available to a secured creditor.\textsuperscript{113} A receiver may be appointed to enforce a charge under the security agreement without the sanction of the court \textsuperscript{114} or by the court order.\textsuperscript{115} Very often the receiver is a qualified accountant or solicitor. Upon appointment, the receiver must act in good faith in recovering the money due under the charge. In doing so, the common law has provided the receiver with extensive administrative power which includes, but is not limited to, the ability to carry on the business of the company (for the purpose of preserving and selling the company as a going concern), to employ and dismiss staff, to make new contracts or abandon old ones, to sell property, to distribute proceeds of sale to those entitled.\textsuperscript{116} The law on receivership thus constitutes an essential remedy for secured creditors in that it ensures efficient preservation of charged assets and minimizes the risk associated with management misconduct.

In contrast, the concept of receiver does not exist in Chinese law. There is no implied power for secured creditor to appoint a delegate to take control of the charged property, neither is there any statutory power to appoint such a delegate. Upon default, Article 195 of the Property Law provides the following methods for secured creditors to realize their security. Firstly, the parties are exhorted to negotiate and agree on the manner in which mortgaged assets are to be realized. If such an agreement cannot be reached, the mortgagee has to apply to the court for an order to auction or judicial sale of the secured

\textsuperscript{113} See for example, For statutory law on the power to appoint receiver by secured creditor, see, for example, s.50 of the \textit{Conveyancing and Property Ordinance}, Hong Kong Ordinances Chapter 219.
\textsuperscript{114} Security documents generally contain very wide powers of appointment such that on default the creditor could take over the business immediately and without the input of any court.
\textsuperscript{115} In \textit{Mandarin Resources Corp Ltd v Cheng Heng Soon} (1988) HK Civ App No 146, the Court of Appeal held that the court had jurisdiction to appoint a receiver where it appeared “just or convenient to do so”. See also \textit{Re Tilt Cove Copper Co.} (1913) UK 2 Ch. 588.
\textsuperscript{116} For statutory powers of receiver, see for example, Schedule 1 to the Insolvency Act 1986 in the United Kingdom, also see s.54 and Fourth Schedule of Companies Ordinance, Hong Kong Ordinances Chapter 32; and s.51 and of the \textit{Conveyancing and Property Ordinance}, Hong Kong Ordinances Chapter 219.
In reality, this provision is inadequate and emblematic of China’s weak remedial system. Negotiations often prove futile due to the borrower’s indebtedness. A survey by the World Bank jointly with People’s Bank of China reported that during 2003-2004, 75% of the enforcement cases of creditor’s rights brought by financial institutions were through judicial processes, the remainder were out-of-court enforcements (17%) or via bankruptcy procedures (8%). Even if where a dispute is brought to the court, many judges lack the expertise and are hesitant to apply the security and bankruptcy laws. This is also disadvantageous to secured creditors as, during the period between the commencement of negotiation and the final court order, which may take months, the management continues to run the company. It is very likely that by the time a court order to freeze the charged assets is issued there is very little left of value. The only remedies available for a secured creditor in this situation is perhaps to utilize the “property preservation” procedures under Article 92 of the Civil Procedure Law 1991, or to apply to the court for the prohibition of certain activities pursuant to Article 74 of the Contract Law 1999. Again, these are slow and costly remedies to procure and often do not help in the preservation of the charged assets for the benefit of the creditor.

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119 It was suggested that Chinese judges lack the experience of hearing bankruptcy cases based on market rules. Only since 1989 have Chinese courts started to accept bankruptcy case. Even if there have been bankruptcies since 1989, most of these cases are policy-oriented bankruptcies and the task of judges in these cases are no more than carrying out the schedules arranged by local government officials. Shi (2007), supra note 81, at 680.
120 Article 92 of Civil Procedure Law of PRC (1991) reads: “If it becomes impossible or difficult to execute a judgment because of the acts of one of the parties or for other reasons, the people’s court may, at the request of the other party, order that property preservation be adopted. In the absence of such request, the people's court may, when necessary, also order to adopt property preservation measures. [...] When a people's court has decided to adopt property preservation, it may instruct the applicant to provide a surety; if the applicant fails to do so, his application shall be rejected.”
121 Article 74 of Contract Law of PRC (1999) reads: “Where the obligor waives its creditor’s right against a third party that is due or assigns its property without reward, thereby harming the obligee’s interests, the
Banks in China apparently understand the defects inherent in the legal system. To them, an *ex ante* risk detection and avoidance system is much more effective than *ex post* remedial measures. Some common measures were discussed earlier including requiring the chargor to buy insurance in respect of secured asset and making the bank a beneficiary under the policy. Requiring the chargor to deposit the pledged / mortgaged asset at the bank’s certified custody service provider in another common protection measure to mitigate the weaknesses in the legal remedy regime. Moreover, from the bank’s internal guideline the risk control mechanisms are tailored to the nature of security. For example, in the case of raw materials, whose value is volatile but where price readily information is available, the bank will monitor price trends in the market. Where the market value of security is below a prescribed threshold, the bank may request the debtor to provide additional collateral, effectively a margin call. Moreover, every secured asset must subject to revaluation at least once a year, and every certified third-party custody service provider has to be re-accredited by the bank at least every two years to ensure probity. Pursuant to the tripartite custody agreement, the bank is entitled to seek compensation from the custody service provider if the latter is found to have colluded with the debtor to allow the asset to be removed from safe custody in violation of the contract.

_oblige may petition the People's Court for cancellation of the obligor's act. Where the obligor assigns its property at a low price which is manifestly unreasonable, thereby harming the obligee’s interests, and the assignee is aware of the situation, the obligee may also petition the People's Court for cancellation of the obligor’s act._"
Finally, given that Chinese law does not permit the creation of floating charge over the entire assets and undertaking of a business, it is impossible for a secured creditor to take over the management of the business as a going concern. Instead, in cases of default, banks expect the custody service provider to control the secured asset and strictly follow the instructions of the bank on the subsequent disposition of the goods. In our view, whilst China lacks professional receivers, in practice, the role and duties of custody service provider are to some limited extent similar to some of the tasks entrusted to a receiver in common law.

4.3.6 Priority Issues

A fundamental objective of any financial security is to enable a secured creditor to have a priority claim in respect of the debtors’ estate in the event of insolvency. The floating charge in England is assigned a subordinate security status compared to a fixed charge over the same assets, and ranks behind preferential creditors who are given the priority by statute, subject to exceptions. Given that a floating security cannot normally be enforced until crystallization has occurred, English insolvency law provides that the priority of an equitable fixed charge that was created as a floating charge is treated as a

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122 This was confirmed in Wheatley v Silkstone & Haigh Moor Coal Co (1885) 29 Ch D 715; because the disposition by the chargor (in creating the mortgage or fixed charge) is permitted by the concept of the floating charge, the grant of a mortgage or charge takes the relevant asset out of the pool of assets caught by the floating charge. However, there is exception when the subsequent fixed charge holder knows about the previously crystallized floating charge, in that case, the floating charge holder will take priority.

123 These preferential creditors generally include those employees and government. See for example in the United Kingdom section 175(2)(b) of the Insolvency Act 1986, s.265 of the Companies Ordinance, Hong Kong Ordinances Chapter 32 (2002).

124 For example, when the subsequent fixed charge holder has actual knowledge of previously crystallized floating charge, the fixed charge holder will lose priority in favour of the prior floating charge See Gough (1996), supra note 35, Part 8 Charge Priority; Palmer’s Company Law supra note 36;
floating charge. The rationale of these priority rules reflects a balance of interests between fixed and floating charge holders, preferential creditors and unsecured creditors.

In stark contrast, the Chinese Property Law provides no distinction between fixed and floating charges in terms of priority. Articles 181, 189 and 196 are all contained in the chapter entitled “general rights of mortgage”. Article 199 enunciates three principles in relation to priority claims over mortgaged property. These are: registered mortgages are paid in order of registration and, if registered on the same date, they are to be paid pro rata; a registered mortgage takes priority over un-registered mortgage; and all unregistered mortgages are paid pro rata.

These three principles have the clear advantage of simplicity from the perspective of creditors, and avoid any confusion with regard to the priority of fixed and floating charges. It follows, that, the rule of first in time of creation of the security interests has very low impact in China in determining priority. Instead, the priority of interests is overwhelmingly determined by the date of registration. Yet, from the perspective of borrowers, by setting the priority rules this way, the possibility of the company raising further debt financing by creating subsequent security over the same assets is hampered, since it is pre-determined that subsequent mortgagees over the same property will never take priority to or rank pari passu in respect of a previously registered security.

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125 See for example section 29(a) of the Insolvency Act 1986
126 Art 199 of Property Law (2007)
Another important issue is the priority between secured creditors and preferential and unsecured creditors. In China, the protection of employees is a prominent issue in the country’s policy-oriented bankruptcy system. Priority in bankruptcy distribution in China has been complicated historically by the need to protect the employees of bankrupt SOEs.127 This sensitivity results from the historical adoption of a command economy, in which the socialist system and the communist ideal was rooted in an implicit guarantee of lifetime employment for the employees of SOEs, giving rise to a hackneyed epithet of the “iron rice bowl”.128 This concept became so pervasive that the state could not countenance mass redundancy as an outcome of bankruptcy either from an economic or ideological standpoint.129 For this reason if secured creditors were allowed priority claims that ranked ahead of sums due to unpaid workers, employees would be left with few, if any, assets to satisfy their claims, so potentially triggering social unrest.130 In reality, many distressed SOEs habitually owed wages and employee benefits in arrears, which further justified the maintenance of priority in favour of employees’ claims over secured

127 In China the SOE’s bankruptcies are subject to the government’s approval, on the premise that SOEs are property of the state. In the past 10 years it seems like the thorniest problem in all of the SOE bankruptcy cases is related to the settlement of employees, which could only be accomplished with financial support from the government. Thus the government and policy intervention seemed a necessity for many cases to proceed. In fact, from 1994 to 2005, China allowed 3658 SOEs to close down, a huge amount of money was set aside to settle the claims of unpaid employees and lessen the effects of social unrest, see China Daily, 2006 WLN 14974543.


129 According to Shi (2007), on the one hand, the notion of bankruptcy, which implied breaking the “iron rice bowl”, undermined the guarantees of economic livelihood for SOE’s employees. See Ta-kuang Chang, 1987, “The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process” 28 Harv. Int’l L. J. 333, 368-369. On the other hand, psychologically, the employees of SOEs were reluctant to accept bankruptcy since it meant a loss of their identity as state workers. See Alex Low, 2006, Bankruptcy Law in China, Corporate Counsel’s Guide to Doing Business in China, Chapter 27, CCG China, 27.15. Shi, supra note 81, at 651 and 684.

130 The root of this problem, as suggested by Low (2006), was that with the shift of China to a market economy, the old social security system of the “iron rice bowl” was detached, yet a new one has not been put in place. See Low (2006), ibid, at Chapter 27.3
Despite these policy considerations, such a practice is inconsistent with almost all industrialized countries where the protection of secured creditors is seen as fundamental to a market credit system. The gradual establishment of the “socialist market economy” and the deepening of SOE reform all militated toward the enactment of an efficient bankruptcy law that protected the interests of creditors, so allowing inefficient firms to exit the market and allowing the remaining assets to be utilized by more efficient firms.

Prior to 2006, the bankruptcy provisions applicable in China were the Enterprise Bankruptcy Law 1986, which applied exclusively to SOEs. In early 1990s, the State Council adopted an array of special policies to protect employees’ interests in SOE restructuring exercises and Decree No. 492 (1996) overturned the priority rules in the Enterprise Bankruptcy Law (1986) by prioritizing the employees of bankrupt SOEs over secured claims. Decree No. 10 (1997) further re-affirmed this position. During the lengthy drafting process of a new bankruptcy code, the issue of priority between secured creditors and preferential creditors was the subject of heated debate. The final EBL

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133 See Art 5 of the 1996 Document No. 492.
134 During this complex debate, various recommendations were put forward to break the impasse. For instance, the suggestion that the absolute priority of secured claims shall be recognized while granting limited priority to the employees’ basic living necessities for a specific period; the bankruptcy enterprises’ managers to bear joint liabilities to deter them from owing employees’ wages in arrears; a compulsory liability insurance regime to be set up to cover employees’ claims; alternatively, the state to bear corresponding liabilities to establish a relief fund to protect the employees in the event of their employer’s bankruptcy, etc. See Shi (2007), supra note 81, at 672, citing Xiaoming Song, “The Court’s Role in the Proceedings of Enterprise Bankruptcy and Restructuring and the Problems that Need To Be Solved”, available at: www.oecd.org/dataoecd/17/30/38167340.pdf (accessed on Nov 11, 2007) and Weiguo Wang, “Administrator in the New Bankruptcy Law of China, paper presented at the Forum on Asia Insolvency Reform 2004: Insolvency Systems and Risk Management in Asia, New Delhi, India, Nov. 3-5, 2004, at 9.
promulgated in 2006 ultimately granted secured claims priority over all unsecured claims,\(^{135}\) confirming that floating charge holders were to be paid in priority to employees and other preferential claims. Notwithstanding, employees’ claims have priority over unpaid taxes and other unsecured claims after bankruptcy expenses and community liability are paid from the bankrupt’s estate.\(^{136}\) This approach is consistent with the protection generally afforded to employees in other jurisdictions and is consistent with relevant international conventions.\(^{137}\) However, the EBL (2006) has adopted a limited, but significant, exception to the general priority rules in that upon the implementation of the 2006 Law; accrued amounts due to employees (including wages, medical expenses, and pension expenses) owed by a debtor enterprise prior to promulgation would still be paid in priority to secured creditors. In other words, after the entry into force of the 2006 EBL on 1 June 2007, secured creditors have priority over employees’ current and accrued claims; however, employees’ claims that were owed prior to the promulgation of the 2006 EBL still rank in priority to secured claims.\(^{138}\)

5. Conclusion

In this article we draw upon the theories of comparative law to construct an analytical framework to examine China’s credit security system with a special focus on the

\(^{135}\) Art 110, 2006 EBL.

\(^{136}\) See Art 113, 2006 EBL. For the range of bankruptcy expenses and community liabilities see Art 41 and 42 of 2006 EBL.

\(^{137}\) For example, the ILO Convention on the Protection of Worker’s Claims in the Event of the Insolvency of Their Employer (1992) requires workers’ claims be paid prior to non-privileged creditors, privileged claims of the State and the social security system and most of other privileged claims. The UNCITRAL Legislative Guide on Insolvency Law (2004) also points out that in a majority of countries, workers’ claims constitute a class of priority claims, which, in a number of cases, rank above tax and social security claims but not the secured claims.

\(^{138}\) See Shi (2007), supra note 81, at 673.
importation of common law rules relating to the floating charge. As widely recognized, a security regime profoundly reflects the legal, historical, political, and even cultural context of the country in which it developed.\textsuperscript{139} For this reason we compared six aspects of the floating charge system under English common law and the Chinese law, in particular the Property Law (2007) and Enterprise Bankruptcy Law (2006). To evaluate the success of such a transplant we examined whether the advantages associated with the application of floating charge are maintained in the local Chinese environment, and whether the application and enforcement of the rules have lead to unintended consequences. We come to the following conclusions.

The necessity to import the English floating charge rules to China is debatable as many leading common law jurisdictions have abandoned the traditional fixed/floating charge dichotomy and radically reformed their personal property security regimes in favour of a notice-filing system. The reform of China’s banking system and the expansion of the SME sector, including agricultural, private manufacturing and service enterprises all increased the need for the creation of additional security devices tailored to the nature of their business operations. China’s continued integration into global financial system also required substantial innovation and the reform of the existing personal property security system. In this regard the Property Law represented a significant experiment in introducing a basic framework of inchoate security. This new framework provides for a security device that can apply to present and future property (albeit narrow in scope), the registration of such interests, and enumerates the events that trigger crystallization. All

these attributes conform to the essential elements of the English floating charge system, though adopting an analogue of the English floating charge with its inherent flaw, which we analyzed in the first part of this article, was in our view suboptimal. Familiarity with the Hong Kong legal system, which retains the floating charge, may have influenced Mainland Chinese legislators. But this choice, on any critical analysis, was flawed.

Nevertheless, if we regard the Property Law as a transitional piece of legislation which will be replaced ultimately by a unified Civil Code covering all civil relationships arising from personal relationships and property transactions, then we think that China should adopt a unified personal property security regime similar to the United States, New Zealand or Australia that would provide a comprehensive solution to the multiple problems and complexities inherent in the English fixed/floating charge system, that we have identified above. The Chinese legislator’s attempt to engraft the common law concept of the floating charge into the 1995 Security Law framework without substantial alteration of the underlying regime was a mistake conceptually and practically. Specifically, compared with the 1995 Security Law, the Property Law simply treats the floating charge as a special type of mortgage that extends to “present or future manufacturing facilities, raw materials, semi-manufactured goods and products”. This extension has been made abruptly without sophisticated consideration of, for example, whether such a provision can be simply added to a system that is fundamentally civilian in origin. Mixing a quintessentially common-law creation into an alien civil structure is fraught with unintended negative consequences and is unlikely to be satisfactory on many levels. The legislator appears not to have considered whether this new type of mortgage
can exist alongside the existing system of pledge over movable property, and whether the
control and enforcement issues, inherent in a well functioning security system have been
addressed adequately. Failure to consider these issues has created a number of practical
difficulties, and may result in either the floating charge security device being unused or
under-used in practice, or the system may be manipulated by businesses to defraud
creditors. Our investigation of Chinese bank practices five years after the introduction of
floating charge confirms this proposition and we are able to demonstrate that only a few
aggressive, non-state owned banks, even attempt to use the floating charge device and
then only in very limited circumstances. In practice, many of the most significant assets
of the company such as trading stock, book debts, and intellectual property rights are still
secured under the Chinese pledge system over movable property, which has its own
inherent disadvantages. Unless these problems are resolved, it is unlikely that floating
charge will become an important security device in the Chinese security system. Perhaps,
rather than attempting to embed an alien legal concept into its present security law
structure, it is the time for China to reconsider its whole credit security system in relation
to personal property. A systematic review should be undertaken, and it may well be
thought that the importation of the English floating charge whilst potentially justifiable as
an interim measure was not the optimal response to the need for a more flexible and
reliable credit security system. As the floating charge has become obsolete in Canada,
New Zealand and Australia and was never adopted in the United States, China may soon
come to realize that a comprehensive overhaul of its current arrangements along the lines
of a notice filing system together with the ancillary infrastructure of a better credit
reporting system and bankruptcy regime, is the correct direction for future legal reform.
Our observations on China’s transplantation of common law floating charge rules contributes to the legal transplant literature by showing the negative consequences of an unsophisticated legal borrowing. Although the German and Swiss Civil Codes primarily influence China’s Property Law, the floating charge system is a product of common law, not the civilian law. The importation of such a security device imposes challenges on China not only as regards its legislative ‘fit’ into the existing security system but also in relation to its reception into the domestic historical, economic and cultural environment. We agree with Watson that transplants are necessary for the legal evolution, especially between the common law and civil law systems, but it is hard to imagine that a floating charge type system could ever be viable in a country, which lacks an established credit-security infrastructure and has habitually ignored creditor’s rights. We also agree with Legrand (2001) and Kahn-Freund (1974) that some legal rules are culturally specific and the adaptation of foreign legal rules to local conditions is a complicated process. In the word of La Porta et al.: “The key point is that transplantation involves not just specific legal rules (many of which actually change later), but also legal institutions (of which judicial independence might be the most important), human capital of the participants in the legal system, and crucially the strategy of the law for dealing with new problems. […] The legal system supplies the fundamental tools for addressing social concerns, and it is that system ... with its codes, distinctive institutions, modes of thought and even ideologies, that is very slow to change.”140 It must be realized that the floating charge as a mature security device was created in England almost 150 years ago in a very different legal and cultural context. Though, at the moment, this imported legal rule has not

produced its intended commercial benefits, it is possible that as China’s more market-based institutions evolve over time, and the failure of this transplant will point the way to a more useful credit-security structure for corporate finance in the future.

Finally, we cannot agree more with Kanda and Milhaupt (2003), who suggest that the motives of the business agents, who are charged with the application and enforcement, have implications for an imported rule’s success or failure. In this article, perhaps the most intriguing findings come from our interviews with Chinese bank credit officers. Despite the poor fit between the imported floating charge rules with the underlying Chinese security system, Chinese banks have been entrepreneurial in developing customized solutions to accept different types of asset as security, and utilize well-designed contractual arrangements to protect their interests. Just as Cooter (1987) puts it: “provided that the legislature clearly defines property and contractual rights and that the legal system enforces those rights, then private agents will negotiate efficient outcomes.” It seems to us that the banks understand better how to reach a balance between the advantages to the economy of facilitating the borrowing of money against the possibility of injustice to creditors, including themselves as lenders. We have noted that Chinese banks use recourse factoring to lend on book debts, use certified custody service providers to exercise physical control over charged assets and obligate these third parties to act as quasi-receiver in the case of default. The banks also use “bottom-line regulation” and insurance to manage credit risks. The banks are also proactive in utilizing state-of-the-art information technology in their internal control systems. These efforts, albeit cumbersome and expensive, increase transaction costs, but they constitute the best

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solution to the credit-risks inherent in commercial lending in China. These tools have evolved in the specific circumstances of the domestic Chinese business environment and have allowed an increase in lending, though a better legislative framework would, of course, allow much increased lending volumes to the private-SME sector and provide credit at lower cost, with more convenience, with less bureaucracy and greater certainty. Unfortunately, the banks have been forced, by defects in the formal legal system, to create a credit-security system that protects their interests whilst at the same time, facilitating the expansion of commercial credit. We consider that thorough reform of China’s credit-security system is necessary to achieve this outcome and assist China’s economic development by supporting the vibrant SME sector.