# THE LAW OF PLEDGES IN THE PEOPLE'S REPUBLIC OF CHINA

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## I. INTRODUCTION

For the first time in the history of the People's Republic of China, the Security Law[1] of China (hereinafter, "Security Law") provides relatively detailed provisions on pledges. There are two types of pledges: the pledge of movable properties (known as "movables") and the pledge of rights (also referred to as the pledge of documentary intangibles). The term pledge of movables refers to the delivery of movables (also referred to as the pledged property) by a debtor (also referred to as the pledgor) or a third party to a creditor (also referred to as the pledgee) for the purpose of securing an obligation.[2] When a debtor fails to perform an obligation, the creditor is entitled to priority in receiving payment by converting the movables into values or proceeds from an auction or sale in accordance with the Security Law. Although the Security Law does not specifically define the term pledge of rights, the Security Law does list the rights capable of being pledged in the following four categories: (i) bills of exchange, cheques, promissory notes, bonds, certificates of deposits, warehouse receipts, and bills of lading; (ii) shares and share certificates that are transferable according to law; (iii) legally transferable exclusive use of trademarks, property rights contained in patent rights and copyrights; and (iv) other legally pledgable rights.[3]

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1. The Secured Interests Law of the People's Republic of China, 1 CHINA L. FOREIGN BUS. ¶5-605 (CCH Austl. Ltd. June 30, 1995)(P.R.C.)[hereinafter Security Law].

2. *Id.* art. 63.

3. *Id.* art. 75.

In this article, I will examine the law of pledges and possible interpretations of the Security Law as it affects the rights and duties of the pledgor and pledgee. I will begin with a general discussion of the utility of secured credit and pledges. Next, I will examine the pledge of movables. Finally, I will analyze the pledge of rights.

## II. THE UTILITY OF SECURED CREDIT AND PLEDGES

Goods may be sold for cash, on credit without security, or on credit reinforced by one of the many available security devices including pledges. Similarly, loans may be extended with or without security. In such credit transactions, the "trade creditor" supplies the goods and the "financial creditor" provides the loan. The term "security" refers to the security taken by a trade or financial creditor in the form of collateral to protect against default on the obligation, particularly debtor insolvency.

It is not entirely clear how the system of secured credit has evolved.[4] Secured credit is recognized not only in the continental jurisdictions but also in the common law jurisdictions. Although the use of secured credit can be traced back to Ancient China and Roman Times, legal history has no prescriptive force.[5] Furthermore, the social utility of secured credit cannot be simply established by concluding that it is the culminating event of hundreds and thousands of years of legal evolution.[6] Nevertheless, we should not dismiss lightly several centuries of legal experience that has become such an integral part of the legal systems of our world.

Contemporary law and economic scholars have searched for the economic justification for secured credit. Professor Goode suggests that the justification for the priority of secured credit traditionally rests on three principles: bargain, value and notice.[7] The weakness of this theory is the assumption that debtors and creditors are fully informed. In reality, there is a substantial group of consensual and non-consensual creditors such as trade creditors, tort claimants, and employees who have little bargaining power.

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4. Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1068 (1984).

5. LI XING LU, THE LAW OF RIGHTS OVER THINGS IN TAIWAN (1993).

6. For more information on secured credit from a historical perspective, see Jacob S. Ziegel, *The New Personal Property Security Regime: Have We Gone Too Far?* 28 ALTA. L. REV. 739, 748-49 (1990).

7. R.M. Goode, *Is the Law Too Favourable to Secured Creditors?*, 8 CAN. BUS. L. J. 53, 57-63 (1983-84).

Professors Thomas Jackson and Anthony Kronman present a sophisticated version of a bargain theory of security.[8] They argue that if security was abolished, lenders anxious to overcome the restriction would have to engage in costly bargaining with competing creditors to secure priority of their claims. To avoid these high costs, the creditors would "authorize" the debtor to bind them by giving security to this particular lender. The problem with the Jackson and Kronman theory is that efficient bargaining among creditors is not possible either ex ante or ex post. Ex ante, general creditors will not know who the debtor's future creditors will be. Ex post, bargaining is impractical due to each creditor's motive of obtaining as much of the debtor's assets as possible, as early as possible.

Alan Schwartz argues, given certain assumptions, that secured credit is a zero sum game.[9] The benefit to the debtor from a lower rate of interest when security is provided is offset by the higher rate of interest demanded by unsecured creditors. In other words, given an informed body of unsecured creditors, neither the debtor nor the unsecured creditors will be any better off. The defect of this theory is the unrealistic assumption that both secured and unsecured creditors are fully informed and risk neutral. In reality, creditors are not equally risk neutral, and they transact in the shadow of uncertainty. Professor Knight takes the view that profit derives from uncertainty.[10]

Because information is not fully available and the degree of risk assumption and the willingness to render monitoring activities are not equally distributed, secured credit is efficient. When information is not fully available, risk averse creditors will only provide secured credit.[11] The degree of risk assumption explains why some creditors use the device of secured credit. Empirical evidence indicates that sophisticated creditors such as banks and other financial institutions more frequently adopt the device of secured credit. However, it is also true that a significant number of bank loans are unsecured. The theory of risk aversion is simply not able to explain the lines drawn by financial creditors such as banks in determining whether security is needed for a specific transaction. Thus, alternative theories are necessary to explain the secured credit system.

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8. Thomas H. Jackson and Anthony T. Kronman, *Security Financing and the Priorities Among Creditors*, 88 YALE L. J. 1143, 1157-58 (1979).

9. Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 7-9 (1981).

10. FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT (Sentry Press 1964) (1921).

11. For information on risk aversion, see James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND L. REV. 473, 491-502 (1984).

The theories on monitoring costs deserve some attention in discussing the utility of secured credit. Professors Jackson and Kronman suggest that the more capable monitors will extend unsecured credit to capitalize on their comparative advantage, while less efficient monitors will take security to reduce monitoring burdens.[12] On the other hand, Saul Levmore argues that the better monitors will take security as compensation for the tendency of less efficient creditors to free ride on their policing efforts.[13]

The problem with the Jackson and Kronman theory is their counterintuitive conclusion that creditors who are typically unsecured, such as trade creditors and employees, are better at monitoring against debtor misbehavior than secured parties such as banks and other financial institutions. The problem with the Levmore theory is that a large portion of loans provided by sophisticated creditors, such as banks, are unsecured.

It can be argued that financial creditors are more likely to increase their monitoring activities where the debtor's identity is important to them, where a transaction is to be followed by similar ones in the future, and where future information is not fully available. Based on these factors, we may predict that when a creditor is willing to assume higher monitoring costs, the creditor will more likely be inclined to provide credit without security. It is also true that the more important the debtor's identity is to the creditor, the higher the probability that the creditor will extend unsecured loans. Finally, unsecured credit is more likely to be given to debtors with good records of similar past transactions. All these behaviors tend to economize on monitoring costs both on loans without security and on loans with security. For those loans without security, financial creditors are more capable than other creditors in monitoring the activities of the debtor's business. For loans with security, financial creditors are able to reduce monitoring costs so that their attention may be focused on unsecured loan transactions. Economizing on monitoring costs is one reason why the same financial creditor may provide both secured and unsecured credit. By focusing their attention on unsecured transactions, financial creditors are better able to solve the problem of agency costs in debt financing, which means that when a debtor is close to insolvency or is insolvent on an asset basis, he is likely to engage in riskier activities which may give him the upside while leaving the downside to the creditors. For secured transactions, the security itself serves the purpose of con-

12. Jackson, *supra* note 8, at 1158-61.

13. Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L. J. 49, 56 (1982).

trolling the agency costs of debt financing. In their process of focusing on unsecured transactions, financial creditors are also able to find worthy users of credit.

As a security device, pledges also meet the objective of efficiency in that they increase the amount of credit to deserving debtors while reducing the agency costs associated with debt financing. However, the requirement of possession in the pledgee seriously restricts the usefulness of pledge in financing modern business transactions, in which it is essential that the borrower remain in possession of the goods, for processing, resale or use.[14] For personal loans, however, pledges are still a useful tool when the consumer delivers gold, jewelry or other non-productive items to the pledgee. Between commercial entities, chattel pledge is less useful. The lack of flexibility gave rise to the pledge of documentary intangibles. The invention of the documentary pledge has made the pledge a somewhat more useful financing device under circumstances involving goods that are in transit, industries which deal in goods such as wines, preserved foods, and other goods which require long-term storage, and under circumstances where an expected quick turnover has not materialized.[15] Comparatively speaking, documentary intangibles are more capable of being transferred. Thus, trade or financial creditors are more likely to use the pledge of rights.

## III. PLEDGE OF MOVABLES

The law of pledges requires the pledgor and pledgee to enter into a written contract.[16] However, the pledge contract is not made effective by the written contract alone. There must be a delivery of the movable to the pledgee.[17] Only when a transfer is executed will the pledge contract become effective. Thus, if there is no transfer of the possession of the movable, the pledge is void either between the pledgor and pledgee or as against a third party.

The Security Law divides the provisions of the pledge contract into mandatory provisions and voluntary provisions.[18] Mandatory provisions include the type and amount of the principal obligation secured; the term for performance of the obligation by the debtor; the name, quantity, quality and state of the pledged property; the scope of the security covered by the

14. Grant Gilmore and Allan Axelrod, *Chattel Security: I*, 57 YALE L. J. 517, 522 (1948).
15. *Id.*
16. Security Law, *supra* note 1, art. 46.
17. *Id.* art. 64.
18. *Id.* art. 65.

pledge; and the time for transferring the pledged property. The parties may freely insert any other provisions into the pledge contract.[19]

The last sentence of Article 65 of the Security Law, which stipulates that pledge contracts which do not contain all of the contents specified in the proceeding provision may be amended, is subject to interpretation and should be approached cautiously. Does it mean that the omission of any of the mandatory provision can be amended? If so, when should the defects be rectified? These questions are yet to be resolved by the Supreme People's Court and are an issue of form versus substance. To serve the purpose of notice to the public, certain formalities are essential. The successful maintenance of a formalized system of law depends on professionalization.[20] When the amateurs come in, the system will break down; the tight, right rules will be replaced by broader and looser categories. Where a sophisticated legal culture is yet to be developed in China, too much emphasis on formalities may cause injustice. It is still the policy of Chinese lawmakers to use plain words and simple sentences when things can be expressed in such a manner. Given these facts, a plausible interpretation should be that a security agreement is not unenforceable against a third party by reason of only a defect, irregularity, omission or error therein or in the execution thereof unless the third party is misled by the defect, irregularity, omission or error.

According to this interpretation, omissions or defects concerning items (1), (2), (4) and (5) of Article 65 can be corrected regardless of the timing of the dispute.[21] Omission, error or defect in the description of the name, quantity, quality, or state of the pledged property should be corrected before a third party is misled or if the purpose of the notice will be destroyed. Given the uncertainty of the language of the Security Law, those who engage in secured transactions in China should make an effort not to make any mistakes in complying with the mandatory provisions of the Security Law. If a mistake were to be made, the mistake should be corrected as early as possible. If a dispute is inevitable, then the above interpretation should be used.

The Security Law prohibits any agreement between the pledgor and the pledgee which calls for the transfer of the property rights to the pledged property from the pledgor to the pledgee if the pledgor fails to fulfill his obligations at the expira-

19. *Id.*

20. Grant Gilmore, *Security Law, Formalism and Article 9*, 47 NEB. L. REV. 659, 670 (1968).

21. *Supra* note 18 art. 65.

tion of the term for performance of the obligation.[22] The purpose of this provision is said to protect the pledgor. However, the focus is misplaced. There is no reason why the freedom of the parties to transact should be restricted by unconcerned parties. If protection of the pledgor is the policy objective, then the policy should be pursued through a rule of unconscionability in the general law of contract. Prohibiting the freedom of the parties to contract inhibits many welfare and/or liberty enhancing transactions.

Unless otherwise agreed, the scope of security by means of a pledge shall cover the principal obligation, interest, liquidated damages, compensatory damages, expenses for the custody of pledged property and realization of the pledge.[23] Because the phrase "the expenses of realizing the collateral" in Article 67 is subject to differing interpretations, the parties should use the permissive language of the article to specify those expenses.

Unless provided otherwise in the pledge contract, the pledgee shall be entitled to the fruits produced by the pledged property.[24] The fruits mentioned shall first be set off against the expenses for obtaining such fruits.

The pledgee has the duty to keep the pledged property in proper custody. Where the pledged property is lost or damaged due to improper custody, the pledgee shall be civilly liable.[25] Furthermore, the pledgor may require the pledgee to lodge the pledged property or propose to fulfil his obligation and request the earlier return of the pledged property if the pledged property is at risk of being lost or damaged due to the inability of the pledgee to keep it in proper custody.[26]

Where there is a chance that the pledged property may be damaged or may diminish in value to an extent sufficient to jeopardize the pledgee's rights, the pledgee may require the pledgor to provide a corresponding security.[27] Where the pledgor refuses to do so, the pledgee may auction or sell the pledged property and agree with the pledgor to use the proceeds from the auction or sale for early fulfillment of the obligation secured, or to deposit the proceeds with a third party agreeable to the pledgor.[28]

When a debtor performs his obligation at the contractually specified time of performance or when a pledgor fulfills his obligation ahead of time, the pledgee shall return the pledged prop-

22. Security Law, *supra* note 1, art. 66.
23. *Id.* art. 67.
24. *Id.* art. 68.
25. *Id.* art. 69(1).
26. *Id.* art. 69(2).
27. *Id.* art. 70.
28. *Id.*

erty.[29] This is called the extinction of pledge by performance. If the pledgee does not receive payment at the expiration of the term for performance of the obligation, he has two options. One is to agree with the pledgor to convert the pledged property into value. The other is to auction or sell the pledged property according to law.[30] After the pledged property has been converted into value or auctioned or sold, any portion of the proceeds that exceeds the amount of the obligation shall be returned to the pledgor and any shortfall shall be paid by the debtor.[31]

The pledge and the obligation secured by the collateral must coexist. The pledge shall be extinguished when the principal obligation secured is gone.[32] The pledge shall also be extinguished by the loss of the collateral. However, compensation obtained for such loss shall be treated as a substitute for the pledged property.

The Security Law only has one provision on third party pledgors. Pursuant to that provision, after the realization of the pledged property by the pledgee, the third party pledgor shall have recourse against the debtor.[33]

## IV. PLEDGE OF RIGHTS

The rights capable of being pledged are mentioned previously. It should be noted that the provisions concerning the pledge of movables apply, mutatis mutandis, to the pledge of rights.[34]

In case of a pledge of bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts or bills of lading, the documents of right shall be delivered to the pledgee within the contractually specified time. The pledge contract shall become effective on the date of the delivery of the documents of right.[35]

Some bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts or bills of lading may specify a date for encashment or delivery of goods. If the date for encashment or delivery of goods under the bills of exchange, cheques, promissory notes, bonds, certificates of deposits, warehouse receipts or bills of lading falls before the term for performance of the principal obligation, the pledgee may cash it or

29. *Id.* art. 71(1).
30. *Id.* art. 71(2).
31. *Id.* art. 71(3).
32. *Id.* art. 74.
33. *Id.* art. 72.
34. *Id.* art. 81.
35. *Id.* art. 76.

deliver the goods prior to the expiration of the term for performance of the principal obligation and may agree with the pledgor to use the amount cashed or the goods delivered for early fulfillment of the obligation secured or to deposit the amount cashed or the goods delivered with a third party agreeable to the pledgor.[36]

The parties concerned shall check the validity and transferability of these documents in accordance with the relevant laws such as the Negotiable Instrument Law,[37] the Maritime Code,[38] and other laws and regulations.

In the case of pledges of share certificates which are transferable according to law, the pledgor and the pledgee shall conclude a written contract and register the pledge with the securities registry. The pledge contract shall become effective on the date of registration.[39] Unless agreed by the pledgor and pledgee, share certificates may not be transferred after they have been pledged. Should the parties agree to a transfer, the proceeds obtained by the pledgor from the transfer of share certificates shall be used for early fulfillment of the secured obligation to the pledgee or deposited with a third party agreeable to the pledgee.[40]

There are many restrictions on the transfer of shares under other applicable laws and regulations. In the case of a pledge of share certificates in a limited liability company, the relevant provisions of the Company Law[41] for the transfer of share certificates shall apply. The pledge contract shall become effective on the date when the pledge of the share certificates is recorded in the register of shareholders.[42] Article 35 of the Company Law makes it possible for shareholders of a limited liability company to freely transfer share certificates among themselves. However, should such share certificates be transferred to persons who are

36. *Id.* art. 77.

37. This law was enacted at the Thirteenth Meeting of the Standing Committee of the Eighth National People's Congress on May 10, 1995 and became effective as of January 1, 1996.

38. This Code was adopted at the 28th Meeting of the Standing Committee of the Seventh National People's Congress on November 7, 1992 and became effective as of July 1, 1993.

39. Security Law, *supra* note 1, art. 78(1).

40. *Id.* art. 78(2).

41. Company Law of the People's Republic of China, 3 CHINA L. FOREIGN BUS. ¶13-518 (CCH Austl. Ltd. Dec. 29, 1993)(P.R.C.)[hereinafter Company Law]. This law was enacted at the Fifth Session of the Standing Committee of the Eighth National People's Congress of China on December 29, 1993 and became effective on July 1, 1994.

42. Security Law, *supra* note 1, art. 78(3).

not shareholders, the consent of over half of the shareholders must be secured.[43]

In addition to the restrictions imposed by Article 35 of the Company Law, there are many other restrictions on the transfer of shares and share certificates. In the first place, promoters of foreign invested joint stock companies are prohibited from transferring their shares within three years after incorporation. Consent from the original approval authorities is needed if their shares are to be sold after three years from the time of incorporation.[44] Foreign invested enterprises, companies with B shares and companies with H or N shares transformed to foreign invested joint stock companies are also subject to this restriction.[45] Similarly, shares of promoters in other joint stock companies are not legally transferable within three years after incorporation.[46] Nor are the shares of directors, supervisors or general managers of joint stock companies transferable during the term of their service.[47] Secondly, the transfer of a party's contribution to the registered capital of an equity joint venture requires consent of the other party or parties, a unanimous board resolution and approval of the transfer by the original examination and approval authorities.[48] Thirdly, shares which are owned by the state and not listed in the Shanghai or Shenzhen Stock Exchanges are not normally transferable unless approved by the relevant government department.[49] Fourthly, A Shares can only be sold to domestic entities or people and B Shares can only be sold to foreign entities or people respectively.

As for legally transferable rights of exclusive use of trademarks, property rights contained in patent rights and copyrights, the pledgor and pledgee should enter into a written contract and register the pledge with the authorities for the administration of

43. Company Law, *supra* note 40, art. 35.

44. Provisional Regulations on Several Issues Concerning the Establishment of Foreign Investment Companies Limited by Shares, art. 8, 3 CHINA L. FOREIGN BUS. ¶13-405 (CCH Austl. Ltd. Jan. 10, 1995)(P.R.C.). These regulations were promulgated by the Ministry of Foreign Trade and Economic Cooperation on January 10, 1995.

45. *Id.* arts. 15, 21 and 23.

46. Company Law, *supra* note 40, art. 147.

47. *Id.*

48. Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, arts. 23, 26, 1 CHINA L. FOREIGN BUS. ¶6-550 (CCH Austl. Ltd. Sept. 20, 1983)(P.R.C.). These regulations were amended and the amendments became effective on January 15, 1986 and December 21, 1987.

49. Provisional Regulations on the Administration of the Issuing and Trading of Stocks, art. 36, 3 CHINA L. FOREIGN BUS. ¶13-574 (CCH Austl. Ltd. Apr. 22, 1993)(P.R.C.). These regulations were promulgated by the State Council on April 12, 1993.

such trademark, patent or copyright.[50] After the rights specified in Article 79 have been pledged, the pledgor may not assign such rights or permit others to use such rights.[51] However, the pledgor may do so upon agreement with the pledgee. The pledge contract shall become effective on the date of registration.[52] The assignment fee or license fee obtained by the pledgor shall be used for early fulfillment of the secured obligation to the pledgee or deposited with a third party agreeable to the pledgee. It has been mentioned that the personal rights contained in patents and copyrights cannot be pledged by negative implication from Article 79 of the Security Law.

## V. CONCLUSION

In matured market economies, pledges are much less useful devices than mortgages. This case is also true in China. However, pledges may play a more important role in China than in any other matured market economies since there are considerable obstacles in the enforcement of general creditors' rights. There are two main sources of these obstacles. First, debt enforcement is difficult as regionalism is prevailing. Second, the insolvency process is not easy to implement. Furthermore, aside from ideological concerns, the normative issue of dealing with the unemployment problem remains to be solved. Given these concerns, trade and financial creditors may consider the use of pledges covering movables and pledges covering documentary intangibles even though realizing pledged properties is much narrower in scope than triggering the insolvency process.

50. Security Law, *supra* note 1, art. 79.
51. *Id.* art. 80.
52. *Id.* art. 79.