

5-14-2019

The Chinese Law of Secured Transactions in Personal Property at a Crossroads: an Analysis and Suggestions

Boris Kozolchyk

Follow this and additional works at: <https://repository.law.miami.edu/umiclrl>

Part of the [International Law Commons](#), and the [Secured Transactions Commons](#)

Recommended Citation

Boris Kozolchyk, *The Chinese Law of Secured Transactions in Personal Property at a Crossroads: an Analysis and Suggestions*, 26 U. Miami Int'l & Comp. L. Rev. 245 ()

Available at: <https://repository.law.miami.edu/umiclrl/vol26/iss2/3>

This Article is brought to you for free and open access by University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami International and Comparative Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.

THE CHINESE LAW OF SECURED TRANSACTIONS IN
PERSONAL PROPERTY AT A CROSSROADS: AN
ANALYSIS AND SUGGESTIONS

Boris Kozolchyk

TABLE OF CONTENTS

I.	INTRODUCTION.....	246
II.	THE SECURITY INTEREST IN THE GENERAL MORTGAGE'S MOVEABLE PROPERTY	253
A.	THE CREATION OF THE SECURITY INTEREST	253
B.	OWNERSHIP OF THE COLLATERAL	258
C.	THE UNCERTAINTY CREATED BY THE REQUIREMENT OF OWNERSHIP OR RIGHT TO DISPOSE OF COLLATERAL... ..	266
D.	WHAT IS INVENTORY AND WHAT ARE PROCEEDS	279
E.	THE PERFECTION OR EFFECTIVENESS OF SECURITY INTERESTS AND THEIR PRIORITY	290
F.	SECURITY INTERESTS AND ECONOMIC DEVELOPMENT	299
G.	NEGATIVE DOCUMENTS OF TITLE.....	310
H.	THE EXTRA JUDICIAL ENFORCEMENT OF THE GENERAL MORTGAGE	316
III.	THE PLEDGE.....	320
A.	WHAT IS THE PLEDGE	320
B.	WHAT COLLATERAL CAN BE PLEDGED?	321
C.	THE CREATION AND THE PERFECTION OR EFFECTIVENESS OF THE PLEDGE	323
D.	THE "SPECIAL CASE": THE PLEDGE OF RECEIVABLES ..	325
E.	THE EXTRA-JUDICIAL REMEDY OF A PLEDGEE'S LIEN..	327
IV.	FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS.	330
A.	FINDINGS	330
B.	CONCLUSIONS AND RECOMMENDATIONS.....	331

I. INTRODUCTION

In January 2015, during the Shanghai colloquium on the Harmonization of Commercial Law in the Trans-Pacific region (hereinafter the Shanghai Colloquium), Dean Shoubin Ni, of the Shanghai University of International Business and Economics (SUIBE) School of Law, and I discussed the state of Chinese secured transactions (hereinafter ST) law, noting that security interests that stem from retentions of ownership or reservations of title, financial leases, transfers of movables in guarantee to creditors, as well as generic mortgages and pledges, are subject to different legal regimes, including overlapping and conflicting filings and priorities. Ms. Emily Yu, Executive Director and Head of the China Treasury Service and Global Trade Legal Department of JPMorgan Chase Bank, added that banks would surely be able to lend larger amounts at lower interest rates and to a larger number of borrowers, including small businesses, if these uncertainties were removed.¹

Despite the adoption of the PRL in 2007,² Dean Shoubin Ni and Feiyu Chen's article, *Movable Property*

¹ See Boris Kozolchyk & NatLaw, *The Second Colloquium for the Harmonization of Commercial Law in The Transpacific Region*, 33 ARIZ. J. INTL. & COMP. L. 1, 4 (2016), http://arizonajournal.org/wp-content/uploads/2016/04/02_Kozolchyk_Intro_1.pdf [hereinafter AJICL Symposium].

² Official sources of English translations of Chinese laws, including the Property Rights Law (PRL) are: Peking University's *LawInfoChina* database, the National People's Congress (NPC) Database of Laws and Regulations ("P.R.C. LAWS"), Westlaw China, the Laws of the People's Republic of China (AsianLII), and the Supreme People's Court Laws & Regulations page. Lyonette Louis-Jacques, *How to Locate Chinese Legislation*

Registration Legislation in China (published in the Arizona Journal of International and Comparative Law 2016, summarizing the Shanghai Colloquium),³ finds a similar level of legal uncertainty as that which prevailed in ST law and practice in the United States prior to the adoption of Article 9 of the U.C.C. in 1958. As will become apparent in the following discussion of the creation (or attachment) of security interests in mortgages and pledges, as well as their effectiveness against third parties (or perfection of the

in English Translation, D'ANGELO L. LIBR. U. CHICAGO L. SCH. (Jan. 31, 2014), <http://news.lib.uchicago.edu/blog/2014/01/31/how-to-locate-chinese-legislation-in-english-translation/>. Therefore, and following the advice of PRC colleagues familiar with both the original Mandarin and its English translation, the English version of the PRL that I will rely on for most of this article will be the Property Law of the People's Republic of China (promulgated by the 10th Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), 2007 P.R.C. LAWS, <http://www.lawinfochina.com/display.aspx?lib=law&id=6642> [hereinafter LAWINFOCHINA PRL]. Occasionally, for the purpose of greater clarity, I will compare various versions of the same provision with translations by Lehman, Lee & Xu. Property Law of the People's Republic of China (promulgated by the 10th Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), 2007 P.R.C. LAWS, http://www.lehmanlaw.com/fileadmin/lehmanlaw_com/laws___regulations/Propoerty_Rights_Law_of_the_PRC_LLX_03162007.pdf [hereinafter LEHMAN, LEE & XU PRL]. I will also use the version that the National People's Congress (NPC) has published. Property Law of the People's Republic of China (promulgated by the 10th Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), 2007 P.R.C. LAWS, http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471118.htm (Jan. 31, 2019) [hereinafter NPC PRL].

³ Shoubin Ni & Feiyu Chen, *Movable Property Registration Legislation in China: Status Quo and Improvement*, 33 ARIZ. J. INT'L & COMP. L. 147 (2015), http://arizonajournal.org/wp-content/uploads/2016/04/12_Ni_147.pdf.

security interest), uncertainty prevails as to the necessary steps to create and perfect these interests. For example, Article 212 of the PRL states: "The right of pledge shall be established after the pledgee [sic, meaning the pledgor] has transferred the pledge."⁴ Similarly, the Lehman, Lee & Xu translation of Article 212 states: "The pledge shall be effective upon delivery of the pledged property."⁵ Accordingly, depending on the meaning of the term "established" or "effective" (and their Mandarin equivalents), these words could be the equivalents of perfection, i.e. the ability to enforce rights against the world at large, and especially third parties, or they could mean the enforcement of rights only between the secured creditor and debtor.

The same is true with Article 180's requirement of the obligor or the third party's "right" to dispose of the collateral as the one that "may be used for a mortgage" of the designated properties, in contrast with the more realistic requirement of the obligor or third party's lawful possession of the collateral.⁶ If ownership or title to the collateral is what is required by the PRL for a debtor (or third party on his behalf) to create a security interest in the collateral, the vast majority of debtors (who are not owners, but are lawful possessors of their movable goods) would be unable to access secured credit at reasonable rates of interest.

In theory, after the promulgation of the PRL in 2007, all the laws applied by the courts of the People's Republic of China (PRC) to mortgages and pledges in movable property are consistent with each other. However, in practice, serious

⁴ LAWINFOCHINA PRL, *supra* note 2, art. 212.

⁵ LEHMAN, LEE & XU PRL, *supra* note 2, art. 212.

⁶ LAWINFOCHINA PRL, *supra* note 2, art. 180.

conflicts between pre-existing, yet still valid, laws and the PRL are common. For example, the Guaranty Law of 1995,⁷ as the forerunner of the PRL, has many provisions that share the same or “almost the same” language as the PRL. Yet, which of the following two “almost the same” provisions should be applied to a dispute between an unregistered secured creditor and a third party? Article 188 of the PRL states that the holder of an unregistered mortgage “shall not challenge [the rights of] any *bone* [sic] *fide third party*.”⁸ In contrast, Article 43 of the Guaranty Law states: “If a party does not register the mortgaged property, he may not defend against the claims of *third party*.”⁹ Note that the latter does not require that the third party act or appear to be acting in good faith. Thus, it is unclear which law would apply where a secured creditor seeks to enforce its rights under an unregistered mortgage of movable property against an unscrupulous third party.

Ideally, a conflicts of law provision should come to the rescue. And Article 8 of the PRL would seem to be such a provision. It provides that “where there is any other special provision on real right in any other law, such special provision shall apply.”¹⁰ Yet, what makes a provision a “special” provision? Is it the one that seems closest to the facts contemplated by the legislature? Could such facts be established when the rules are directly contrary – when, for

⁷ Guaranty Law of the People’s Republic of China (promulgated by the Standing Committee Nat’l People’s Cong., Jun. 30, 1995) 1995 P.R.C. LAWS, http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383719.htm [hereinafter GUARANTY LAW].

⁸ LAWINFOCHINA PRL, *supra* note 2, art. 188 (emphasis added).

⁹ See GUARANTY LAW, *supra* note 7, art. 43.

¹⁰ LAWINFOCHINA PRL, *supra* note 2, art. 8.

example, one is designed for third parties in general and the other only for bona fide parties?

In addition, according to Dean Shoubin Ni and Feiyu Chen, many uncertainties are largely attributable to a dysfunctional decentralized registration system. In their words:

The high level of decentralization of registration authorities also directly reduces the chance for the movable property owner, and in particular, for small- and medium-sized enterprises to find financing in the market. On the one hand, many new types of property rights are difficult to register due to the unclear registration rules. On the other hand, for those property rights that can be registered, the decentralized registration system actually jeopardizes the credibility value of the [assets of the filing] enterprises"¹¹

In their opinion, a major source of the registration uncertainty stems from the lack of distinction between the registration of movable property for strictly administrative or governmental purposes and for the determination of title to the collateral:

The administrative registration of movable property is generally needed for the operational safety or for industrial administration; this is the case with the registration of vessels, aircrafts and automobiles. Other movable property . . . such as equipment for hoisting machines, or elevators and others . . . are supposed to be registered . . . to maintain public safety. [In contrast,] title registration is for preventing and settling [private parties'] conflicts involving their rights *in rem*.¹²

¹¹ Ni & Chen, *supra* note 3, at 159.

¹² *Id.*

To reduce these uncertainties, among others, the SUIBE Law School expressed an interest in working with the Kozolchyk National Law Center (hereinafter NatLaw) and with local and international banks to complete a comparative law evaluation of the effectiveness of the ST provisions of the PRL. The evaluation was to start with an empirical analysis of its effects upon the availability of commercial credit in Shanghai, especially for small and mid-sized business owners. It would be followed by an analysis of the PRL and related laws' text and relevant judicial decisions. Based upon this analysis, the research team would recommend statutory and regulatory improvements. Some justices of the People's Supreme Court (PSC), as well as some legal advisors of the PRC's Central Bank, showed an interest in participating in this project.

Unfortunately, this joint project did not materialize, except for two informal visits that SUIBE law students and I made to a group of small Shanghai businesses. During these visits, we discussed Shanghai credit and ST practices and why secured lending at reasonable rates of interest had not yet taken root among Shanghai business owners (I will refer to these visits later as the "Shanghai Interviews"). Despite the inability to commence the joint research, I promised Dean Shoubin Ni that I would review the English translations of the PRC laws that he listed among those most frequently applicable, and I would report to him my findings and recommendations on what our two institutions could do together in the near future. The SUIBE Law School had been extremely hospitable to NatLaw and had honored me with an *Honoris Causa* degree. Unfortunately, for serious health reasons, among others, I was not able to fulfill my promise until now, with this article, which comprises the second part

to chapter 19 of the second edition of my text *Comparative Commercial Contracts*.¹³

In addition to providing a better understanding of China's ST law, this article attempts to rekindle China's and the international secured lending community's interest in comparative evaluations of the PRL and its counterparts in the Asia Pacific region. Given the importance of ST law for the Chinese and Asian economies, as well as for the nations that trade with these economies, I believe that the joint task Dean Shoubin Ni and I agreed to should benefit, not only the economies of the Asia Pacific region, but also those beyond. With this purpose in mind, I will discuss key PRL provisions on "General Mortgages" and pledges, as well as related provisions of other laws still in effect, especially the Guaranty Law of 1995,¹⁴ the Law of the People's Republic of China on Land Contracts in Rural Areas of 2002 (hereinafter LLCR),¹⁵ and the Contract Law of the People's Republic of China of 1999 (hereinafter PRC Contract Law).¹⁶ These provisions involve successively, the creation, effectiveness or perfection, and priority of security interests in movable property.

¹³ BORIS KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS: LAW, CULTURE AND ECONOMIC DEVELOPMENT* (2d ed. 2019).

¹⁴ GUARANTY LAW, *supra* note 7.

¹⁵ See Law of the People's Republic of China on Land Contracts in Rural Areas (promulgated by the Standing Committee of 9th Nat'l People's Cong., Aug. 29, 2002), 2002 P.R.C. LAWS, http://www.npc.gov.cn/englishnpc/Law/2007-12/06/content_1382125.htm [hereinafter LLCR].

¹⁶ Contract Law of the People's Republic of China, (promulgated Mar. 15, 1999, effective Oct. 1, 1999) 1999 P.R.C. LAWS, <http://www1.lawinfochina.com/display.aspx?lib=law&id=6145&EncodingName=big5> [hereinafter CONTRACT LAW].

II. THE SECURITY INTEREST IN THE GENERAL MORTGAGE'S MOVABLE PROPERTY

Does the creation of a security interest in a general mortgage require the execution of a security agreement between the mortgagor and mortgagee, or is it sufficient if the mortgagor unilaterally acknowledges in a filing with the appropriate registry that he has mortgaged the property to a designated mortgagee?

A. THE CREATION OF THE SECURITY INTEREST: THE SECURITY AGREEMENT

The PRL provisions on the creation of a security interest are few but some appear to be inconsistent *inter se*. One such provision is Article 23, located in the PRL Section on Basic Principles: “The *creation* or transfer of the real right of a movable property shall become effective upon delivery, except [if] it is otherwise prescribed by any law.”¹⁷ Is this basic principle saying that the conclusion of an agreement between a future secured lender and borrower does not bind them, regardless of how serious and formal their agreement may be, unless the collateral is delivered to the secured creditor?

Other provisions found in the General Mortgage Section, such as Articles 181 and 185, seem to be the laws referred to in Article 23 as “prescribing otherwise.” Article 181 states:

Upon the written agreement between the parties concerned, an enterprise, individual industrial and

¹⁷ LAWINFOCHINA PRL, *supra* note 2, art. 23 (emphasis added).

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 obligor fails to pay its/his due debts or any circumstance for realizing the right to mortgage as stipulated by the parties concerned occurs, the obligee shall be entitled to seek preferred payments from the movable properties that exist when the parties concerned stipulate to realize the right to mortgage.¹⁸

Even more directly and contradictorily, Article 185 provides: *To create a right to mortgage, the parties concerned shall conclude a mortgage contract in written form. A mortgage contract shall generally include the following clauses.*

- (1) The variety and amount of the obligee's rights as secured;
- (2) The time limit for the obligor to pay debts;
- (3) The name, amount, quality, condition, location, attribution of ownership or use right of the property under mortgage; and

¹⁸ *Id.* art. 181. In the United States, the U.C.C.'s Article 9 inspired the use of the generic clause "present and hereafter acquired" to signify a continuing security interest in the same type of collateral, such as a store's inventory. U.C.C. §§ 9-101 - 709 (AM. LAW INST. 2001, as amended), <https://www.law.cornell.edu/ucc> [hereinafter U.C.C.]. The Lehman, Lee & Xu translation of the PRL most closely resembles that practice. Lehman, Lee & Xu use "existing and future," while NPC uses "existing and anticipated," and *LawInfoChina* uses "owned or is going to own." The latter is problematic wording in light of what is being discussed in the principal text. The NPC version of Article 181 is: "Subject to written agreement between the parties, enterprises, self-employed industrial and commercial households and agricultural producers and distributors may mortgage their existing and anticipated production equipment, raw and semi-finished materials, semi-finished products and finished products."

(4) The range of security.¹⁹

Yet, as was discussed in the Introduction, Article 212 of the PRL states: “The right of pledge shall be established after the pledgee [sic; pledgor] has transferred the pledge.”²⁰ This would seem to mean that Article 23 was drafted having in mind only the creation of a security interest in a pledge and not in a mortgage. If so, to create a security interest in a mortgage, the parties would have to first execute a security agreement.

One of the first points discussed during the Shanghai Colloquium was, as Dean Shoubin Ni referred to it, the “Misunderstanding of the Doctrine of Creation upon Registration.” In the article he co-authored with Professor Feiyu Chen, these scholars note: “Under the PRL, it is not clear whether the registration results ‘in the establishment of the title to the property, or just entitles the registration applicant to defend its title against any *bona fide* third party.’ ”²¹

To illustrate the confusion, they referred to the example of the PRC Trust Law, which provides that: to the extent required by relevant laws and administrative regulations, trust property shall be registered according to applicable law upon the establishment of trust If the trust property is not registered, it shall be registered retroactively,

¹⁹ LAWINFOCHINA PRL, *supra* note 2, art. 185 (emphasis added).

²⁰ See LEHMAN, LEE & XU PRL, *supra* note 2, art. 212 (“The pledge shall be effective upon delivery of the pledged property.”); see also LAWINFOCHINA PRL, *supra* note 2, art. 212.

²¹ Ni & Chen, *supra* note 3, at 160.

and a failure to register shall lead to the invalidity of the trust.²²

This regulation confuses the scope of the secured loan agreement, which pertains to the grant of a credit to the debtor and the effects of the registration of the security interest. As restated by these authors:

*The effectiveness of the credit and debt contract shall not be affected even if the movable property has not been registered. The security interest (or registration) of the movable property just "increases the credibility" of the credit and debt contract, which shall be deemed an independent legal act to the effect of recorded lien vis-à-vis third party creditors and bona fide purchasers of the collateral. According to the relevant principles in most jurisdictions worldwide, such registration is not a necessary pre-condition to the establishment of security rights over the movable property.*²³

This criticism can also be validly directed against Article 23 of the PRL, which suggests that movables be delivered to a secured creditor before the secured creditor and the debtor are considered bound by their security agreement. While it is true that the delivery of a mortgaged or pledged movable property to the secured creditor is a form of "public notice," delivery should not be a determinant of the valid creation of a security interest by the parties, *inter se*, to a security agreement. An example is a notation in the corporate records of X corporation indicating that the identified shares of stock have been pledged to secured creditor Y to secure

²² *Id.* (quoting Trust Law of the People's Republic of China (promulgated by the Standing Committee Nat'l People's Cong., April 28, 2001), art. 10, 2001 P.R.C. Laws).

²³ *Id.*

payment of debt Z. In my opinion, Dean Shoubin Ni and Feiyu Chen make a valid and important distinction in the above-emphasized statement: The function of a secured credit agreement is to assure the borrower that his lender is committed to lend, while the function of the registration is to warn third parties that the security interest has been perfected on the described collateral.

However, I would disagree with my PRC colleagues if their assumption is that the function of the registry of secured transactions is to effect “the registration of the ownership of or title to the movable property.” As will be discussed in the following section, the obligor-mortgagor should not be expected to prove that he is the owner of the movable goods that comprise the collateral that secures the loan and when registering his security interest. Half a century of experience with registering security interests in movable property has taught this author what has been known since the middle ages, as will be discussed shortly: Since the right of the secured creditor is not that of owner but that of a preferential possessor of the collateral, it does not need to prove its ownership and thus file a “chain of title” type of documentation. All it needs to do is to have entered into a security agreement with the debtor, or be the recipient of a security interest by operation of the law, and then provide the summary notice required for the type of collateral involved. Meanwhile, as stated by Section 9-202 of the U.C.C.: “Title to [the] Collateral [is] Immaterial.” Quite often, the secured creditor under the U.C.C. will be able to describe the collateral in terms as terse as “inventory” or “accounts” or “proceeds.” This type of information is consistent with the changing or transformable and often highly perishable nature of movable property. It is also the type of information that least exposes secured creditors to bad faith “causal” defenses by debtors.

For defaulting debtors are known to eagerly invoke any and all of the terms and conditions of the security agreement to justify their non-payment of the debt or interference with a summary execution. In other words, the terse nature of the financing statement (contemplated under the U.C.C.) lends itself most to a fair and speedy enforcement of the preferential possessory rights inherent in perfected security interests. Meanwhile, the door is still open for the good faith debtor to bring a subsequent action for unjust enrichment or breach of the underlying loan, sale, or lease agreement, if justifiable.

B. OWNERSHIP OF THE COLLATERAL AND THE CREATION OF A SECURITY INTEREST

Chapter 16, Section 1 of the PRL is supposed to distinguish a seemingly all-encompassing “general mortgage” on real and “personal” or movable property from what an Anglo-American lawyer would refer to as a chattel mortgage, i.e., a mortgage in personal or movable goods, or what a contemporary Spanish or Latin American civil law lawyer would refer to as a “mortgage in movables” (*hipoteca mobiliaria*). Aligning itself with the Romanistic tradition then, the “Chinese generic mortgage” (*di ya*), like its Roman law *hypotheca* ancestor,²⁴ encompasses both immovable and movable property.²⁵ Accordingly, Article 179 of the PRL, whose task was to define the General Mortgage, states:

²⁴ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 24:3(B) and especially the opinion of the Roman jurist Marcian on the interchangeability of mortgages and pledges in Roman classical law.

²⁵ See MARK WILLIAMS, HAITIAN LU & CHIN AUN ONG, *SECURED FINANCE LAW IN CHINA AND HONG KONG* 69-71 (2010) (discussing the *Di Ya* or generic Chinese mortgage).

An obligor (debtor) or a third party may, for the security of the payment of debts, mortgage his properties to the obligee (creditor) without transferring the possession of such properties, and when the obligor fails to pay due debts or any circumstance for realizing the mortgage right as stipulated by the parties concerned occurs, the obligee shall be entitled to seek preferred payments from such properties.²⁶

Article 179 makes clear that the debtor remains in possession of the collateral but leaves other important questions unanswered. The most important is the type of right that the mortgagor must have to its collateral. Is it an ownership right or would a possessory right, such as that of a lessee or “usufructuary”²⁷ (i.e., someone given the right to use and retain the yield of the land or of movable property), suffice? Dean Shoubin Ni and Professor Feiyu Chen would require that the PRC’s registry for movables, like its registry for immovables, revolve around ownership or title to property. Yet, other than by saying that the mortgagor does not have to transfer his right to possession of the mortgaged property to the mortgagee, Article 179 of the PRL does not answer our query as to what sort of right over the collateral is required to create the mortgage. Further, this article does not clarify if the creation of a generic mortgage requires that the mortgagor have the rights enumerated by Article 39 of the PRL (“the rights to possess, use, profit from and dispose of the movable or immovable property”), or if it suffices that the

²⁶ LAWINFOCHINA PRL, *supra* note 2, art. 179.

²⁷ On the rights of a usufructuary, Article 117 of the LAWINFOCHINA PRL states: “The owner of the usufructuary right shall, within the extent permitted by law, enjoy the right to possess, utilize and obtain profits from the real or movable properties owned by others.” *Id.* art. 117.

mortgagor have one of the rights listed by Article 39.²⁸ In addition, does the mortgagor's *right to mortgage the collateral*, whatever it may be, have to be recorded somewhere, such as frequently happens around the world with mortgaged or pledged automobiles or other valuable movable property identifiable by serial number, among other indicia?

However, as discussed earlier, Article 180 of the PRL does require that the obligor have *the right to dispose* of the collateral, whether movable or immovable. Nevertheless, the right to dispose of a movable or immovable is but one of several rights associated by the Romans with ownership (*ius domini*), including the right to use and exploit if not "abuse" the property. On the other hand, it should be noted that a non-owner can enjoy the right to dispose of property if it is fully empowered to do so by an owner. Finally, a non-owning creditor can also exercise the right to dispose of property in order to recover what was owed to the creditor by repossessing that property and selling it publicly or privately (*ius distrahendi*). Article 180 provides:

The following properties *to which the obligor or the third party has the right to dispose of* may be used [as collateral] for mortgage [transactions]:

- (1) Buildings and other fixed objects on the ground;
- (2) The right to use land for construction;
- (3) The right to contracted management of barren land, etc. as obtained by means of bid invitation, auction and public consultation, etc.;
- (4) Manufacturing facilities, raw materials, semi-manufactured goods and products;

²⁸ LAWINFOCHINA PRL, *supra* note 2, art. 39.

(5) Buildings, vessels and aircraft that are under construction;

(6) Means of communications and transportation;

(7) *The properties other than those that shall not be mortgaged according to any law or administrative regulation.*

A mortgagor may mortgage all the properties listed in the previous paragraph together.²⁹

Where ownership of land is concerned, Article 10 of the PRC Constitution of 1982 provides that land in the cities is owned by the State, and land in rural and suburban areas is owned by collectives.³⁰ Under the same Constitution, what is considered to be “privately owned” (in the sense that it could be disposed of) does not seem to include anything resembling commercial assets. In fact, while the 1982 version of Article 13 of the PRC 1982 Constitution set forth the right to “own lawfully earned income, savings, houses and other lawful property,” its 2004 amendment deleted this language.

Nonetheless, the PRL came to the rescue of private property (or “personal” property, as Soviet law used to describe it³¹) by enabling the sale of assets as follows: “The owner of a real property or movable property has the rights to possess, use, seek profits from *and dispose of* the real property or movable property according to law.”³² Article 40, in turn, acknowledges that “[t]he owner of a real or movable property has the right to establish a usufructuary right or real right for security over the real or movable property.” In

²⁹ LAWINFOCHINA PRL, *supra* note 2, art. 180 (emphasis added).

³⁰ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.3.C.

³¹ See *id.* § 16.1.A.

³² LAWINFOCHINA PRL, *supra* note 2, art. 39 (emphasis added).

addition, as if to emphasize a private individual's power to create security interests in private or "personal" goods, Article 64 of the PRL assures the secured creditor that: "An individual is entitled to the ownership of his legal income, premise[s], household goods, instruments of production, raw materials and other real and movable properties." But, Article 64 does not provide a clue as to the identity of these properties.

i. Why Title to Movable Collateral is Unnecessary and Uneconomic: A Bit of Comparative Commercial Legal History

It did not take long for the truth of the maxim "movables cannot be pursued" (*mobilia non habent sequelam*; or in more legal terms, "title to movables cannot be tracked") to reveal itself. First, it became clear to medieval merchants (whether as sellers or buyers of movable goods, or as lenders on the strength of such property) and, thereafter, to the rest of the trading world. All it took was for budding medieval merchants to migrate from their feudally-enclosed villages to larger "open" markets in cities and fairs. Once these merchants started doing business in open markets and entrusting their goods to intermediaries, whether empowering them to sell or lease their goods or not, title to the goods became untraceable and, thus, meaningless. As pointed out by Frederick Pollock and Frederic William Maitland, two of England's greatest legal historians:

When French and German law take shape in the thirteenth century, they contain a rule which is sometimes stated by the words *Mobilia non habent sequelam* [or the French] (*Les meubles n'ont pas de suite*), or, to use a somewhat enigmatical phrase that became current in Germany, *Hand muss Hand wahren*. Their scheme seems to be this: —If my goods go out of my possession without or against my will—

if they are unlawfully taken from me, or if I lose them – I may recover them from any one into whose possession they have come; but if, on the other hand, I have of my own free will parted with the possession of them – if I have deposited them, or let or lent or pledged, or “bailed” them in any manner – then I can have no action for their recovery from a third possessor. I have bailed my horse to A; if A sells or pledges it to X, or if X unlawfully takes it from A, or if A loses and X finds it – in none of these cases have I an action against X; my only action is an action against my bailee, against A or the heirs of A: “Where I have put my trust, there must I seek it.” [*Hand muss Hand wahren*]. . . . If my goods go from me without my will, I can recover them from the hundredth hand, however clean it may be; if they go from me with my will, I have no action against anyone except my bailee.³³

By the time the *Code Civil* was enacted in 1804, the protection of the buyers who acquired movables in the increasingly open markets and shops became a paramount concern. Not surprisingly, the *mobilis* maxim was replaced by Article 2279: “*En fait des meubles, la possession vaut titre*” (“In matters of movables, possession is the equivalent of title.”).

Further, once mid-19th century world-wide maritime commerce became dependent upon “documents of title” (such as negotiable bills of lading and warehouse receipts) that entitled their holders to claim the immediate delivery of goods comprised therein by their carriers and warehousemen, the “fragmentation” of ownership rights (a favorite expression of my teacher F. H. Lawson) over those

³³ See SIR FREDERICK POLLOCK & FREDRIC WILLIAM MAITLAND, 2 THE HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I. 155 (2nd ed. 1909).

movables became a business and legal reality. The same is true for the large number of disputes between, on the one hand, sellers and buyers, and, on the other, between merchants and holders of documents of title, usually acting as creditors secured by these documents. According to some sales laws and practices, the buyers were supposed to obtain title to the goods from the moment they and their sellers agreed on the goods to be sold and their prices. Frequently, however, the sellers would only sell on credit if they could “retain” their title to the goods until they were paid. On the other hand, the creditors would only extend credit if they became holders of negotiable documents of title covering the same goods sold. Thus, the holders of the documents of title could obtain immediate delivery of the goods by carriers or warehousemen by merely tendering these documents to them, regardless of who claimed to be the “historical” owner of the goods.

ii. *Measures (Regulations) for Chattel Mortgage Registration (2016 Revision): 动产抵押登记办法(2016修订)*³⁴

The Measures (Regulations) for the Chattel Mortgage Registration (hereinafter MRCHM) were intended to reduce some of the serious uncertainties faced by mortgage rights

³⁴ Dongchan Diya Dengji Banfa (动产抵押登记办法(2016修订)) [Measures for Chattel Mortgage Registration (2016 Revision)] (promulgated by the St. Admin. for Industry & Com. of the People's Republic of China, Jul. 5, 2016, effective Sep. 1, 2016), art. 2, LAWINFOCHINA, <http://www.lawinfochina.com/display.aspx?lib=law&id=22385> [hereinafter MRCHM].

under the PRL (uncertainties discussed in the previous sections and illustrated by the Hao Hao Company Case in the following section). I shall postpone the discussion of the possible reduction of uncertainties until we conclude the discussion of the aforementioned case. The MRCHM provides:

Article 2 Where enterprises, individual businesses and agricultural production operators take out movables mortgage under Item 4, Paragraph 1 of Article 180 and Article 181 of the Real Rights Law of the People's Republic of China, they shall apply for registration with the administrative authorities for industry and commerce at the county level (the "Registration Authorities") in the place where mortgagor is located. The right to mortgage shall be established upon the execution of a mortgage contract. Without the registration, the right to mortgage shall not challenge any bone (sic) fide third party. For the purposes of these MRCHM's, the administrative authorities for industry and commerce shall include the market regulatory authorities that perform the duties of the administration for industry and commerce.

Article 3 The party to a mortgage contract or the agent entrusted by both parties shall apply for the registration, re-registration and de-registration of movables mortgage with the (above) registration authorities...The person concerned shall ensure the authenticity and accuracy of the documents submitted. (Parenthesis added).

Article 4 Where the right to mortgage established by the person concerned conforms to Article 2 hereof, he or she shall apply for registration of the establishment of the right to mortgage with the registration authorities by holding the following documents.

1. the Registration Certificate of a Mortgage on Movables (hereafter MRC)' signed or stamped by mortgagor and mortgagee;
2. the certificate of subject qualification or personal identity of mortgagor and mortgagee;
3. the identity certificate of the proxy appointed or agent entrusted by the parties to the mortgage contract.

Article 5 The MRC shall contain the following contents:

1. the title (name) and residence (premise) of mortgagor and mortgagee;
2. the name, quantity, quality, status, location, ownership or the right to use it;
3. the variety and amount of the secured creditor's rights;
4. the scope of collateral;
5. the time limit for paying debts by debtor;
6. the name and contact number of the proxy appointed or agent entrusted by the parties to the mortgage contract;
7. signature or stamp by mortgagor and mortgagee;
8. other information on the right to mortgage that mortgagor and mortgagee deem it necessary to be registered.³⁵

C. THE UNCERTAINTY CREATED BY THE REQUIREMENT OF OWNERSHIP OR RIGHT TO DISPOSE OF THE COLLATERAL: HAO HAO'S CASE.

Recent PRC case law illustrates vividly the uncertainties of reliance on the mortgagor's alleged ownership of the collateral, unsupported by an easier to establish preferential possessory right to his corporeal movable property. The following decision by the Higher

³⁵ *Id.*

(Appellate) People's Court of Guangdong Province is dated June 26, 2015.³⁶ Hao Hao Company, an aluminum merchant, purchased raw aluminum on credit from an aluminum seller. Hao Hao obtained a "Mortgage for a Maximum Amount" (more on this mortgage shortly) from Ping An Bank to finance this acquisition. The loan was for "up to 80 million yuan" during a fixed one-year period. Hao Hao and the Bank agreed that all the mortgaged unprocessed aluminum would be stored in a processing factory owned by Yaohuang Processing Plant, and that this aluminum would be mortgaged to secure the repayment of the Bank's loan. Upon storage, the Bank registered its mortgage and obtained an MRC from the registry in its County District. This mortgage registration certificate referred to the collateral as "all unprocessed aluminum stored at Yaohuang Plant."

Subsequently, the Yaohuang Plant sent an acknowledgment to the Bank that it was storing the unprocessed aluminum for Hao Hao, who had "claimed ownership" over all the stored aluminum at the plant. Yaohuang Plant also acknowledged that, according to the Bank's MRC, the collateral included "all existing and future

³⁶ Fushan Shi Yin Nuo Lu Ye Youxian Gongsi Yu Ping'an Yinhang Gufen Youxian Gongsi Fushan Fenhong Ershen Minshi Panjueshu (佛山市银诺铝业有限公司与平安银行股份有限公司佛山分行二审民事判决书) [Foshan City Yinnuo Aluminum Co., Ltd. & Ping An Bank Co. Ltd., Foshan Branch Second Instance Civil Judgement Book], WENSHU CT. (Guangdong Higher People's Ct. 2015), <http://wenshu.court.gov.cn/content/content?DocID=f7795c97-6588-4924-962a-24876ff52f6a&KeyWord=%EF%BC%882015%EF%BC%89%E7%B2%A%E9%AB%98%E6%B3%95%E6%B0%91%E4%BA%8C%E7%BB%88%E5%AD%97%E7%AC%AC980%E5%8F%B7>.

aluminum materials" stored in the Yaohuang plant, and that the Bank had custodial rights over this collateral. In addition, *the Bank put up a street sign on the Plant's wall indicating that the aluminum stored in Yaohuang Plant belonged to the Bank.*³⁷

Sometime after this, Yinnuo, another aluminum merchant in need of aluminum processing services by Yaohuang Plant, stored its unprocessed aluminum in the Yaohuang Plant. This storage was part of a "consignment processing contract." Under the consignment contract, Yaohuang Plant was entrusted with Yinnuo's unprocessed aluminum materials, as processor and consignee (presumably as a future seller) of Yinnuo's aluminum.

A dispute ensued over whether Hao Hao defaulted in its repayment to the Bank, and the dispute was submitted to an Arbitration Commission. The Arbitration Commission held that the Bank had unquestioned priority over the aluminum stored at the Yaohuang Plant. This dispute continued before a trial court, where the Bank obtained an order of seizure of all the aluminum stored with Yaohuang Plant, including that stored by Yinnuo.

The trial court held that the Bank's seizure of all the aluminum at Yaohuang Plant was lawful. It found that

³⁷ *Id.* This is a striking illustration of the "living law" regarding registrations of security interests in personal property in the PRC. It seems that the court's reference to the fact that a sign was placed in front of the warehouse claiming the Bank's its rights in rem on the deposited goods indicates that this is a method that the Bank, regardless of registrations, found necessary in order to provide "real" or "living law" notice to third parties as the holder of preferential possessory rights to the collateral. Secondly, it is important to note that despite the court's reliance on the principle that possession is the equivalent of title, the Bank referred to itself as the owner of everything inside the warehouse.

because the Bank's MRC listed Hao Hao's name as that of the mortgagor, and the Yaohuang Plant acknowledged that all the materials in the Plant belonged to the Bank, the Bank had priority to all aluminum stored in the Yaohuang Plant. Yinnuo, however, was able to identify as its own 48,416 tons of aluminum by its packaging, branding, and location in the Plant. The trial court agreed that Yinnuo had positively identified the materials as its rightful property. Even so, the trial court held that Yinnuo was not entitled to have those 48,416 tons of aluminum back from the Bank given the nature of the deposited aluminum as fungible goods and subject to a present and hereafter acquired clause (the agreement that the collateral comprised "all existing and future aluminum materials"). Nonetheless, Yinnuo, as the entruster of aluminum to the Yaohuang Plant—and not having granted a power to transfer its aluminum to any third parties, including the Bank—had a claim against the Yaohuang Plant for the value of its aluminum materials. The trial court relied on PRL Article 106, which states:

Where the real or movable property is transferred to a transferee by a person without the power to do so, the rightful owner shall have the right to recover such property. Unless otherwise provided by law, the transferee shall obtain the ownership respecting such real or movable property in any of the following events:

- (i) The Transferee accepts the transfer in a bona fide;
- (ii) Such property is transferred with a reasonable price;

(iii) The transferred property has been registered in accordance with the laws requiring such registration, and those not required to be registered has been delivered to the transferee.

Where the transferee has obtained the ownership . . . in accordance with the preceding paragraph, the original holder of the right shall enjoy the right to claim damages from the non-holder of the right to dispose of the property³⁸

On appeal, Yinnuo repeated its lower court argument that the Bank had no right to seize the tonnage that Yinnuo had identified as its property (namely 48,416 tons of aluminum materials), and it also argued that it had rightful priority to another 3.8 tons of aluminum materials that it had not been able to physically identify. The Bank countered, arguing that the Arbitration Commission had decided that the Bank had priority over all aluminum deposited in the Yaohuang Plant, and that decision deserved *res judicata* treatment. It also asserted that, even if the aluminum seized belonged to Yinnuo, PRL Article 106 protected the Bank as a good faith mortgagee. This was true especially because Hao Hao's unrepaid loan to the Bank qualified as a reasonable price for the aluminum it seized, so the Bank satisfied the requirement of PRL Article 106(ii). Thus, the Bank had the right to enforce its seizure of all materials in the Yaohuang Plant as the holder of a priority right.

The Appellate Court reversed in part, stating that the trial court had erroneously treated Yaohuang Plant as if it

³⁸ LEHMAN, LEE & XU PRL, *supra* note 2, art. 106.

were a warehouse empowered to issue warehouse receipts, which it was not.³⁹ Accordingly, the fact that warehouse receipts were not issued, and thus were not available to identify the materials deposited in the Plant, was not, in the Appellate Court's opinion, dispositive. The Court also rejected the trial court's application of PRL Article 106, as it was not controlling; instead, the Court applied PRL Articles 181 and 196 and held that the Bank was a good faith mortgagee so, upon Hao Hao's default, the Bank had the right to seize its mortgaged materials. However, because Yinnuo was able to prove its ownership of 48,416 tons of aluminum, Yinnuo had a right to the return of that material. Still, the Appellate Court agreed with the trial court that the Bank had the right to seize the property that Yinnuo could not identify and which had been stored in the Yaohuang Plant.

Commentary: The Requirement of Ownership of the Collateral and the Legal Uncertainty of Security Interests.

i. Yinnuo's Ownership Right

As we have discussed in previous sections, the requirement of ownership of the collateral in the PRL creates serious uncertainties to the ease of transmission, transformation and identification of collateral. For this

³⁹ Chapter 20 of the above discussed 1999 Contract Law "governs many areas relevant to warehouse receipts, including the power to transfer a warehouse receipt by negotiation. . . ." Article 381 defines a warehousing contract, Article 385 requires the issuance of a warehouse receipt [when appropriate], Article 386 sets forth its formalities, Article 387 provides for the transfer of a warehouse receipt, and finally, Article 392 requires the presentation of the warehouse receipt as a condition to release the goods. CONTRACT LAW, *supra* note 16.

reason, it should not surprise that the rules related to ownership result in vagueness, inconsistency and “invertebration.”⁴⁰ Examples of these problems are found in the following articles of the PRL (LawInfoChina) some of which we have discussed previously:

Article 8: When there is any other special provision on a real right in any other law that special provision shall prevail.

Article 33: As for a dispute over the ownership or content of a real right, the interested parties can petition for the confirmation of their rights.

Article 39: The owner of a real property or movable property has the rights to possess, use, seek profits from or dispose of his property in accordance to the applicable law.

Given the generality and vagueness of the previous rules, it should not surprise that when the Bank tried to give public notice of its purported ownership right in the warehoused aluminum, it also decided to paint a sign on the outside wall of Yaohuang’s plant. Likewise, when Yinnuo tried to establish the chain of title to his fungible and otherwise unidentifiable aluminum, it relied on evidence of the manner in which it was originally packed and of the location of the packed aluminum in Yaohuang’s plant. Obviously, Yinnuo’s difficulties in tracing his aluminum were

⁴⁰ An “invertebrate” legal system is a legal system whose rules are unpredictable because they are arbitrarily fashioned and applied by administrative or judicial officials at each level of decision-making and adjudication, without regard for pre-existing rules or principles, except those (mostly in the form of slogans) attributable to officials at the very top of the normative pyramid. This type of legal system is, paradoxically, common in authoritarian societies.

caused by the fungibility and transferability of his claimed 3.8 tons of unprocessed aluminum.

iii. *The Bank's Possessory Right and the MRC*

In contrast with the difficulties of having to prove Yinnuo's ownership over 3.8 tons of aluminum, the Bank could rely on the MRC as official prima facie evidence. This document described the movable collateral property as "the unprocessed aluminum warehoused in Yaohuang's warehouse by the Bank in addition to replacement aluminum as warehoused by Hao Hao or the Bank." Despite the generalities of the preceding descriptions, they provide greater certainty with respect to what the collateral is and what the rights of its mortgagee are. Accordingly, the Appellate Court did not base the bank's repossession of the collateral on an ownership right but on a right to the possession of the goods described by the MRC.

The difficulties that must have been found by the mortgagees trying to repossess mortgaged goods during the first eleven years of the life of the PRL are reflected in the previously transcribed Articles 2 through 5 of the MRCHM (see *supra* 1 (b)). The liability for the accuracy of the assertions made by the diverse documents required by Article 3 is placed with the filers of the information; they are responsible for "the veracity, precision and authenticity of the filed data." Probably, this regulation may have been motivated by the constant forgery of official documents filed with courts during the days of Imperial Chinese Law.⁴¹

⁴¹ KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.

iv. The Preferential Possession of the Legitimate Holder of Documents of Title

A certificate or receipt of deposit issued by a warehouse authorized to issue such a document or an ocean bill of lading issued by the “carrier of the vessel” incorporates rights to the preferential possession of the goods described by each document. When the Appellate Court in the present case distinguished an authorized certificate or receipt from that issued by Yaohuang’s warehouse (which was not authorized to issue such a document), the court suggested that if the Bank or Yinnuo were legitimate holders of an authorized document, they could claim the immediate delivery of the 3.8 tons of aluminum warehoused by Yinnuo or by the Bank. Although the preferential possessory consequences of holding authorized documents were not fully spelled out, the fact that the court, *sua sponte*, was willing to draw the distinction is an encouraging sign of its willingness to rely in future cases on possessory rather than full ownership rights.

v. “Mortgages for a Maximum Amount,” “Opening of Credit,” “Line of Credit” Agreements, and the Financing of Inventory and Proceeds

The small-business Shanghai merchants I interviewed during the Shanghai Interviews in 2016 referred to a “Mortgage for Maximum Amount” as one that they frequently used as borrowers. It consisted of being lent a certain amount of money at the “opening” of the credit, during which time the lender commits to lend up to a specified total amount agreed on by the parties at the outset. As the borrower takes funds from the bank, the pre-specified

maximum amount decreases until the lending limit is met, and all funds that the bank was willing to lend are exhausted. However, by mutual agreement, the parties could terminate the agreement earlier than specified in the agreed-upon expiration date or they could enter into a new agreement.

The collateral for a Mortgage for Maximum Amount is the same allowed for a General Mortgage. Under PRL Article 181, such collateral may include: “manufacturing facilities, raw materials, semi-manufactured goods and products it has already owned or is going to own . . .”.⁴² A Mortgage for a Maximum Amount is also described in rather vague terms by Article 203:

An obligor or third party may, for the security of payment of debts, provide [the] security of [a] mortgage to the obligee for the obligee’s rights that will continuously occur within a certain term, and when the obligor 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 security properties within the maximum amount of obligee’s rights.

The obligee’s rights that have existed before the right to obtain a mortgage for a maximum amount is established and may be incorporated into the scope of obligee’s rights under the security by mortgage at maximum amount.⁴³

The descriptions of the Shanghai merchants during the Shanghai Interviews plus the language of PRL Article 203 lead me to conclude that the this Mortgage is similar to that used to secure a type of commercial loan that was popular in

⁴² LAWINFOCHINA PRL, *supra* note 2, art. 181.

⁴³ *Id.* art. 203.

early 20th century France and Spain—a contract of “opening of credit” (*ouverture de crédit* or *apertura de crédito*).⁴⁴ This is a “static” contract in that, during the stipulated period of availability, the amount of credit available is fixed “up to a maximum amount,” which is not dependent on the borrower’s sales volume or profits or on the amount of assets it could use to repay the loan, including inventory and proceeds.

In contrast, the commercial credit contract, which has proven most effective for small- and medium-sized businesses in Canada, the United States, Germany and Latin American countries is the so-called “Line of Credit Agreement.” In a Line of Credit Agreement, especially in the “revolving” and “cumulative” variety, when the credit account is opened by the lending bank, the bank places a certain sum of money at the disposal of the borrower, based, among other factors, on the totality of eligible collateral.⁴⁵ The borrower can use available funds under the “revolving” and “cumulative” lines to purchase more inventory or the raw materials and equipment needed to produce or sell more goods, and continue to reinvest the proceeds into business assets. As the borrower’s assets increase and become more liquid, the borrower can request, or the lender can offer, to

⁴⁴ See BORIS KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS: A COMPARATIVE STUDY OF CONTEMPORARY COMMERCIAL TRANSACTIONS* (1966).

⁴⁵ The revolving credit account is well known in German law and practice. Section 355 of the German Commercial Code (HGB) refers to it as *Laufende Rechnung* (or a “running balance” account). See MARTIN PELZER & ELIZABETH VOIGHT, *HANDELSGESETZBUCH/GERMAN COMMERCIAL CODE* 309 (in German & English; 5th revised ed., 2003).

increase the loan amount.⁴⁶ Yet, and this is an important qualification: A line of credit agreement, if it is of the “revolving and cumulative” kind, relies on a highly “fluid” concept of inventory and proceeds.

The PRL’s closest mention of the concept of inventory is in Article 180(4), which references “raw materials, semi-manufactured goods, and products.” Note, however, that this is a static description of goods; the materials referenced could be part of an inventory, but the Article does not refer to the fact that the materials are held by the debtor for sale or lease and that they are expected to be replaced by similar raw materials, manufactured or semi-manufactured goods, and products. Just as important, it does not mention that the security interest in that inventory will continue to be effective or perfected as the goods sold become: 1) contract rights to collect proceeds upon the seller’s delivery of the goods to the buyer;⁴⁷ 2) accounts receivable, upon performance of the

⁴⁶ See generally, Campbell R. Harvey, *Line of Credit*, THE FREE FIN. DICTIONARY (2012),

<https://financial-dictionary.thefreedictionary.com/line+of+credit>.

⁴⁷ It is true that some contemporary ST laws, such as the present U.C.C. Article 9, were amended to have the collateral known as “accounts” absorb the former collateral known as “contract rights.” See U.C.C., *supra* note 18, § 9-102(a)(2). In doing this, Article 9 erased the dividing line between contract rights (not yet earned by performance) and accounts (which reflect performed contracts). The first (unnumbered) comment of the 1972 version places contract rights under “general intangibles:” “The term general intangibles brings under this article miscellaneous types of contract rights and other personal property which are used or may become commercial security. Examples are goodwill, literary rights and rights to performance [of contracts].” U.C.C. § 9-106 cmt. at 609 (1972). I added “of contracts,” which was frequently missed by interpreters and commentators of this provision. U.C.C., *supra* note 18, § 9-106, in turn,

contract rights; 3) money or negotiable instruments received in payment of the account and, if it is cash, whether in the seller's cash registry or as bank deposits; or 4) replacements for the inventory sold or new inventory acquired with the aforementioned assets.

What's more, despite the fact that PRL Article 185(4) refers to a section in the security agreement where a statement on "the range of the security" should be placed, Article 191 considerably limits the utility of the "range" or coverage of a security interest in inventory, accounts, and proceeds financing when it states that:

If a mortgagor transfers mortgaged property with the consent of the mortgagee during the period of mortgage, the proceeds which the mortgagor *obtains from the transfer of the mortgaged property shall be used to liquidate the claim secured by the mortgage or it shall be deposited with a third party agreed upon by the mortgagor and the mortgagee.*

If the proceeds exceed the claim, the balance shall belong to the mortgagor; if the proceeds do not cover the claim, the difference shall be paid by the debtor.⁴⁸

defined "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." This definition led some of us teaching Article 9 in the seventies to draw the most common line of distinction between contract rights and accounts by referring to the former "as rights not yet earned by performance." In fact, some of us, wanted to retain the distinction and suggested that the U.C.C. comment should make that distinction as clear as possible. This writer's experience with the value of contract rights as collateral in developing nations suggests the need for preserving the independence of contract rights collateral, especially as one of the most relied upon forms of collateral by micro- and small businesses.

⁴⁸ LEHMAN, LEE & XU PRL, *supra* note 2, art. 191 (emphasis added).

And, as if to emphasize the static nature of this loan, it adds:

The mortgagor may not transfer the mortgaged property without consent of the mortgagee during the period of mortgage, unless the transferee pays off debts on behalf of mortgagor and the right of mortgage lapses.⁴⁹

In other words, Article 191 of the PRL stops the flow of assets linked with the concept of inventory and also linked to a continuous or revolving set of proceeds. As will be recalled, that flow of assets starts with the contract rights against the buyer or lessee (prior to them being earned by performance), and is followed by accounts receivable, due, and payable (once earned by performance), and thereafter, by the payment of proceeds. It must be emphasized that, pursuant to Article 191, once the first payment of the sale of inventory goods is received by the mortgagor, seller, or lessor, it cannot use these proceeds in order to acquire more inventory or other business assets, which is essential to continue building up a higher-valued inventory to use as collateral for its line of credit. I should add that, when we asked the Shanghai small-business merchants whether they had ever been granted a line of credit secured by inventory, accounts, and proceeds, their response was that they had never heard about such financing.

D. WHAT IS INVENTORY AND WHAT ARE PROCEEDS

⁴⁹ *Id.*

The reader will recall that Article 185 of the PRL specifies that a mortgage contract shall generally include the following clauses:

- (1) The variety and amount of the obligee's rights as secured;
- (2) The time limit for the obligor to pay debts;
- (3) The name, amount, quality, condition, location, attribution of ownership or use right of the property under mortgage; and
- (4) The range of security.⁵⁰

From an ST standpoint, the concept of inventory is essential, but it must be fluid and dynamic. In my teaching days, I used to analogize this concept to the Greek philosopher Heraclitus's notion of the "being" of things: *Panta Rhei* (an incessant flow). Accordingly, unless inventory collateral and its proceeds are incessantly fluid and revolving, they will not provide the amount of credit and the rates of interest that small- and medium-sized businesses need for their growth. This is not the case under the PRL. In contrast, definitions from Article 9 of the U.C.C. and from NatLaw's 12 Principles of Secured Transactions Law in the Americas provide a model for legislators to follow to imbue "inventory" with the fluid and revolving characteristics necessary to support economic development. For example, inventory is defined by U.C.C. § 9-102(48) thus:

Inventory means goods, other than farm products, which:
(A) are leased by a person as lessor;

⁵⁰ LAWINFOCHINA PRL, *supra* note 2, art. 185.

(B) are held by a person for sale or lease or to be furnished under a contract of service;

(C) are furnished by a person under a contract of service;
or

(D) consist of raw materials, work in process, or materials used or consumed in a business.

Proceeds are defined by U.C.C. § 9-102(64) thus:

Proceeds, except as used in Section 9-609(b), means the following property:

(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

In turn, Article 3 of NatLaw's 12 Principles of Secured Transactions Law in the Americas provides:

The security interest may be created in any personal property susceptible to monetary valuation whether present or future, tangible or intangible including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. Thus, personal property collateral, as well as security interests in them, are open in number (*numerus apertus*), and these security interests are not limited to pre-existing devices, such as a pledge, with or without

dispossession of the collateral, chattel mortgages, retention of title or conditional sales, etc.⁵¹

i. The Function of the Description of the Collateral in the Security Agreement and in the Financing Statement

As discussed in *Comparative Commercial Contracts*,⁵² the function of the security agreement is to establish the terms and conditions of the lenders and borrowers, including their reciprocal promises, rights, and duties. The description of the collateral in the security agreement is usually more detailed than in the financing statement. For this reason, the security agreement is more relied on in litigation, especially in bankruptcy claims over preferential, specified assets. In contrast, the purpose of the financing statement is to provide a summary notice of the creditor's security interest in generally described collateral; yet, it must be a notice sufficient to warn third parties, such as possible future buyers of the collateral or secured lenders, of what was mortgaged or pledged. In the final analysis, reasonableness is what dictates what should be included in the financing statement as

⁵¹ See NLCIFT 12 PRINCIPLES OF SECURED TRANSACTIONS LAW IN THE AMERICAS, NATIONAL LAW CENTER FOR INTER-AMERICAN FREE TRADE (2006), <http://www.natlaw.com/sites/default/files/NLCIFT-12-Principles-of-Secured-Transactions-Law-in-the-Americas.pdf> [hereinafter 12 NatLaw Principles]. The NLCIFT became NatLaw on May 30, 2018. See *The National Law Center for Inter-American Free Trade is Renamed the Kozolchik National Law Center*, NATLAW, http://natlaw.com/news_posts/national-law-center-inter-american-free-trade-renamed-kozolchik-national-law-center/ (Feb. 1, 2019).

⁵² See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.I.A.

sufficient notice to an average future buyer or creditor. Since the PRL says very little on the description of the collateral, it is up to the PRC courts to provide the necessary guidance to filers.

ii. The Proper Description of Collateral in a Mortgage of Corporeal Things: The Quncheng Decision

Because the PRL says very little on collateral description, especially on the admissibility of generic or detailed descriptions, it would be the responsibility of PRC courts to provide the necessary guidance. The following discussion of an important recent court decision provides support for this assertion.

In this 2015 decision, *China National Automobile Industry Import & Export Company* (hereinafter CNAC) *v.* *Yizheng Quncheng Rural Microfinance Company Ltd.* (hereinafter Quncheng),⁵³ an appeals court had to decide whether CNAC, as the first-in-time secured lender, had priority over Quncheng, the last-in-time secured lender. The

⁵³ Zhongguo Qiche Gongye Jin Chukou Youxian Gongsi Yu Yizheng Shi Qun Cheng Nongcun Xiao E Daikuan Youxian Gongsi, Yizheng Jiang Haiyang Zaochuan Youxian Gongsi Xiao E Jiekuan Hetong Jiufen Ershen Minshi Panjueshu (中国汽车工业进出口有限公司与仪征市群成农村小额贷款有限公司、仪征江海洋造船有限公司小额借款合同纠纷二审民事判决书) [China Nat'l Automobile Industry Import & Export Company *v.* Yizheng Quncheng Rural Microfinance Company Ltd.], WENSHU CT. (Hubei Higher People's Ct. 2015), <http://wenshu.court.gov.cn/content/content?DocID=c1a62964-e6a2-4245-8407-9ec401c4b7d4&KeyWord=%EF%BC%882015%EF%BC%89%E9%84%82%E6%B0%91%E5%9B%9B%E7%BB%88%E5%AD%97%E7%AC%AC00086%E5%8F%B7>.

collateral, two large ships, had been mortgaged by Yizheng Jianghai Shipbuilding Company, Ltd. (hereinafter Jiang Hai), first to CNAC and subsequently to Quncheng, to secure loan agreements. The trial court found that *CNAC had priority to the collateral in question, and the appeals court affirmed.*

The relevant facts were that in 2009, Jiang Hai, a ship builder, entered into an agreement with COMBI, a carrier. In it, Jiang Hai agreed to build two ships for COMBI, and COMBI agreed to finance Jiang Hai's purchase of the raw materials to build the two ships in exchange for a security interest in the materials purchased with COMBI's financing. The agreement stated that COMBI would invest 5.96 million yuan in building the two ships. It also stated that, as the investor, COMBI would be the sole owner of all parts and materials, including parts under construction, built vessels, and the raw materials and equipment it purchased or prepared for the purpose of constructing the ships, from start to completion. Jiang Hai had no right to dispose of any materials or parts; it only had rights to use the materials to build the two ships. COMBI paid the 5.96 million yuan to Jiang Hai within three months of signing their agreement. In 2012, after Jiang Hai had built one ship, COMBI decided to terminate its relationship with Jiang Hai and waived any claim to monies Jiang Hai had not repaid. Another investor/lender, CNAC, agreed to replace COMBI under the 2009 contract. Jiang Hai then completed building the second ship. After the ships were completed, Jiang Hai took a loan from Quncheng in the amount of 4.8 million yuan and mortgaged as collateral for the loan "abandoned ship raw materials." In fact, the materials so described were the ships that Jiang Hai had built under the 2009 contract. These "abandoned ship raw materials" were valued at just over 8.4 million yuan, so Quncheng accepted the collateral and

entered into a Maximum Mortgage Contract with Jiang Hai. Quncheng and Jiang Hai registered this new Maximum Mortgage Contract with the Industry and Commerce Bureau in their local county. Attached to the registration application was a “list of mortgaged items” and the principal item was described as “inventory – abandoned ship.”

Jiang Hai defaulted on Quncheng’s loan, so Quncheng sued Jiang Hai to determine what was owed to it under the contract. The parties resorted to a conciliation proceeding and agreed that Quncheng had a priority right to the ships because the ships had been mortgaged as collateral by Jiang Hai to guarantee its loan. In 2013, CNAC learned of the conciliation proceeding between Jiang Hai and Quncheng and filed its own claim against Quncheng in maritime court. The maritime court held that CNAC was the rightful owner of the ships. It also found that CNAC’s claim invalidated the Maximum Mortgage Contract signed between Jiang Hai and Quncheng. The maritime court noted that a ship is not “raw materials.” Even if the misnomer was an innocent mistake, the ships in this case had not been “abandoned”; CNAC claimed the ships, even though COMBI could be said to have abandoned the project some years earlier. Jiang Hai had acted in bad faith when he claimed that the collateral was “abandoned ship raw materials,” and Quncheng was wrong to accept the description without verifying that it was accurate, as discussed below.

Because of the faulty description, under the PRC Regulations for Ship Registrations, the Mortgage was registered in the wrong registry. Rather than registering the Agreement in the ship registry, they registered in the movable goods registry, where security interests in raw materials are filed. The erroneous description and the fact that no interest in the ships had been registered meant that, under PRL Article

180,⁵⁴ *Jiang Hai's and Quncheng's security agreement (the Mortgage for a Maximum Amount) was invalid*. The collateral mortgaged under the agreement did not exist; there were, in actuality, no "abandoned ship raw materials" and, though the ships did exist and were under Jiang Hai's control, there was no registered security interest in them.

Quncheng appealed the maritime court ruling to a court of first instance, arguing that the conciliation court's finding that the mortgage contract was good confirmed the contract's validity. The court of first instance agreed with the maritime court that the Mortgage for a Maximum Amount was invalid. It added that Jiang Hai did not have a right to mortgage either the ships or "abandoned ship raw materials" as collateral *because it did not own the ships*, and there did not exist any abandoned ship raw materials. It also decided that the conciliation court's holding could not confirm the validity of a mortgage whose validity was not an issue before it. Thus, the court held that, under PRL Article 108, the Mortgage between Jiang Hai and Quncheng was invalid, and CNAC as the first secured lender had priority to all materials under its 2009 contract with Jiang Hai.

Quncheng appealed these holdings. The appellate court relied on several laws for its conclusion. First, it confirmed that, under Article 34 of the Guaranty Law,⁵⁵ all machines and modes of transportation can be mortgaged. Then, it cited Article 37 of the Guaranty Law⁵⁶ for the rule that, *where it is unclear who owns or has use rights to a piece of property, or if there is a dispute involving the property, that*

⁵⁴ LAWINFOCHINA PRL, *supra* note 2, art. 180.

⁵⁵ GUARANTY LAW, *supra* note 7, art. 34.

⁵⁶ *Id.* art. 37.

property may not be mortgaged. Finally, it cited the Supreme People's Court Opinion on Several Issues Concerning the Implementation of the General Principles of the Civil Law of the People's Republic of China Article 113⁵⁷ *for the premise that a mortgage based on collateral that a pledgor does not own or have the right to manage is invalid.*

In this case, it was clear that CNAC, as a successor to COMBI's ownership, owned the building materials and the ships built with them; Jiang Hai did not own them. Therefore, Jiang Hai did not have the right to mortgage the ships as its collateral. Further, the ships had not been abandoned; indeed, CNAC claimed that it owned the ships, and the shipbuilding contract between CNAC and Jiang Hai confirmed that CNAC was the rightful owner of the ships. Quncheng had acted unreasonably when it accepted "abandoned ship raw materials" as collateral for a mortgage without any supporting evidence to validate that Jiang Hai owned the collateral, and that it was what it was claimed to be in their agreement (abandoned raw materials). Thus, Quncheng's mortgage contract with Jiang Hai was not valid, and CNAC had priority to the collateral under its agreement with Jiang Hai.

Commentary: Please notice the courts' continuous reliance on the requirement of the mortgagor's ownership of the collateral in order to validate both the creation of a security interest and its perfection. But please also note that courts of

⁵⁷ Opinions of the Supreme People's Court on Several Issues Concerning the Implementation of the General Principles of the Civil Law of the People's Republic of China (Trial Implementation) (issued by the Jud. Committee of the Sup. People's Ct., Jan. 26, 1988), art. 113, SINA BLOG, http://blog.sina.com.cn/s/blog_540752bd0100u0e5.html.

different jurisdictions, such as a maritime court, can make their own determination whether CNAC (as a mortgagee) is also the owner of the vessel or vessels in dispute. Yet, was it one or two ships? Were they “regular” or “abandoned” vessels? Or, was CNAC the owner of “abandoned ship raw materials”? Unless the collateral is properly identified in the security agreement and subsequently in the properly filed financing statement, it would be very difficult, if not impossible, for any court to determine who owns what right in what property or collateral. Hence, this case illustrates vividly the importance of legislative or regulatory guidance to secured creditors as well as to registrars and courts on the appropriate description for collateral.

Taking into account Jiang Hai’s and Quncheng’s misrepresentation of the existence of collateral that, in fact, according to the Appellate Court, belonged to CNAC, it is surprising that the courts refrained from sanctioning Jiang Hai’s (and, potentially, Quncheng’s) dishonest, bad faith behavior. In addition, the reliance on Article 180 as a closed list of collateral and, *pari passu*, of security interests, is equally troublesome. Assume that Jiang Hai owned unencumbered, actual, abandoned ships and that as ship building materials they had sufficient market value and could be used in good faith as raw materials for the building of a new ship; what would be the reason for invalidating the mortgage that relied on them and their description? If the ST policy is to encourage lending that is supported by sound collateral and good faith practices, should not a future revision of the PRL support an open-ended approach to the admissibility of new types of collateral to which the marketplace attributes value and to new security interests in them?

Another illustration of the need to revise the PRL is provided by PRL Article 181. It describes the contents of a

type of security agreement, but it adds uncertainty regarding the meaning of Article 180's "right to dispose" (of property) by including in the definition of movables the phrase "[that] the mortgagor has owned or is going to own." Article 181 provides:

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 obligor fails to pay its/his due debts or any circumstance for realizing the right to mortgage as stipulated by the parties concerned occurs, the obligee shall be entitled to seek preferred payments from the movable properties that exist when the parties concerned stipulate to realize the right to mortgage.⁵⁸

How would a mortgagor under a mortgage of movable property be able to identify the raw materials, semi-manufactured goods, and products that the borrower already owns, or better still, is going to own for purposes of registering a security interest in them? If what the mortgagor is trying to establish is the ownership of movables, what evidence of past or future ownership would be required? It may well be that what the PRL drafters intended with such an open-ended description of collateral was a generic form of property, such as a store's inventory, thereby echoing what is described in some United States financing statements as "present and after acquired collateral," such as new inventory, goods, and proceeds. If that is the intention of the PRL drafters, the PRL should include a definition that

⁵⁸ LAWINFOCHINA PRL, *supra* note 2, art. 181 (emphasis added).

categorizes goods as inventory and link the definition to the proceeds from the sale of inventory. For, as noted in the preceding Subsection 4, the financing of credit to small- and medium-sized businesses is dependent on a well-drafted definition of inventory and proceeds. It is worth mentioning that in 2015, one year prior to the promulgation of MRCHM (whose Article 5(2) equated the possessory right of use of a movable property to ownership over the property), the PRC's Supreme Tribunal had enforced this right of possession in the case where the mortgagor had the right to administer such collateral.⁵⁹

E. THE PERFECTION OR EFFECTIVENESS OF SECURITY INTERESTS AND THEIR PRIORITY

i. Is the Preregistration or Pre-Advice of a Future Mortgage over Movable Property Allowed?

As will be recalled, article 2 of the MRCHM provides that an industrial or agricultural enterprise that mortgages the property specified in articles 180 & 181 of the PRL shall be able to register the mortgage with the administrative department for industry and commerce for the appropriate county (hereinafter referred to as "authorized registry"). This provision concludes with a warning that the mere conclusion of a mortgage agreement, without it being recorded, will not affect the rights of a third party in good faith.

Occasionally, a creditor-mortgagee about to lend may wish to obtain the earliest possible priority by filing what is known in some jurisdictions as a "preventive" or "advance"

⁵⁹ Opinions of the Supreme People's Court, *supra* note 57.

notice of a willingness to lend in the near future. Such a notice must be accompanied by a good faith expectation that credit will be granted in the immediate future. If it is not granted and that creditor's notice prevents the debtor from getting another loan, such creditor should be held responsible for the damages caused to the debtor by its unwarranted notice. The PRL does not contain any provision allowing for a provisional or advance notice of filing.

It would appear that Article 188 of the PRL as well as Article 2 of the MRCHM are not receptive to this useful practice. Both Articles require that the contract of the mortgage be concluded prior to there being a filing about this contract. If "by concluding the contract" it means that there has been a disbursement of the mortgage loan, the purpose of the pre-advice would be frustrated. On the other hand, if "by concluding the contract" it is meant "formal execution and signature" (prior to the disbursement of the loan), then the advance notice practice might be feasible.

ii. *What Is a Functional Notice?: The Importance of a Unitary Security System*

Another serious problem with Article 6 of the PRL is the insufficiency of the notice to third parties by the delivery of possession of different types of collateral to the creditor. As stated, in relevant part, by Principle 5 of the 12 NatLaw Principles: "A principal goal of a secured transactions public notice system is to eliminate secret liens."⁶⁰ At times, public notice of a lien can be attained by a third party's sensorial awareness of the existence of the lien, such as by examining

⁶⁰ See 12 NatLaw Principles, *supra* note 51.

an endorsement or notation on a negotiable instrument or document of title in the hands of the endorsee or of someone designated to receive its delivery. This endorsement and delivery functions as valid notice of the perfection of a security interest because its presence is apparent at plain sight to likely buyers of the instrument or document as well as to lenders on the strength of such documents or instruments. These buyers or lenders are usually bankers or merchants familiar with these documents.

Accordingly, effectiveness of a notice must be linked to the *reasonableness* of the legislative assumptions about what makes third parties aware of the presence of a security interest. Thus, before legislators decide on how and where a security interest should be perfected, they must ask themselves: "If I were a potential purchaser of that collateral, or a potential lender wishing to rely on strength and market value of the particular collateral as security, where would I most likely search for such information?" The answer dictates that security interests that are filed should be capable of reflecting what different types of lenders are likely to know about the collateral and what information is more likely to provide a functional and effective notice of the existence of liens.

In addition, more than 50 years of world-wide experience with effective notice systems and reliance on functional electronic notice systems teaches that a security interest must be unitary; in other words, instead of there being various types of security in the same collateral, often interchangeable, they should all be reduced to one type of security interest, similarly perfected and subject to the same rules of priority, thereby facilitating the determinations of perfection and priority of all. Imagine the uncertainty that would prevail if one creditor could claim that its unregistered

conditional sale or financial lease conferred on it a right superior in rank and time of enforcement to any filed security interest. Alternatively, consider a scenario where security interests in sold raw materials were deemed inferior to security interests in accounts receivable that resulted from the sale of the raw materials, perfected by means other than registration. Incidentally, for a number of years, this type of uncertainty prevailed with unrecorded “sales with reservation of title” and “financial” leases in a number of Latin American countries. It is for this reason that Principle 6 of the 12 NatLaw Principles states:

Effective public notice by a specialized registry occurs *when all known or future* legal mechanisms with the effect of guaranteeing the payment of a debt against personal property are treated as a unitary security interest. The effect of such a recorded security interest, including its priority, upon third parties (such as other secured creditors and purchasers) commences from the time of its filing, irrespective of the time of its creation.⁶¹

iii. *Where to Register a Mortgage on Movable Property:
The Chencang Bank Decision*

Article 189 of the PRL states in relevant part:

In case an enterprise, individual industrial and commercial household, or agricultural production operator mortgages any of the movable properties prescribed in Article 181 of this Law, *it shall register with the administrative*

⁶¹ *Id.* at Principle 6 (emphasis added).

*department for industry and commerce at the place where the mortgagor resides.*⁶²

Even though the terms *residence*, *enterprise*, and *individual and commercial household* are not defined, as we will discuss shortly, these are this Article's less troublesome problems. The choice of location ("the administrative department for industry and commerce at the place where the mortgagor resides") seems reasonable provided that it is not, as discussed in *Comparative Commercial Contracts*,⁶³ a registry of ownership of or title to movables, but a registry of financing statements searchable by debtors' names, rather than by the description of collateral. For, a search by a description of collateral is usually associated with registries capable of creating new rights *in rem*, such as the German land registry (*Grundbuch*), whose ability to establish the "chain of title" to real property was undoubted and is now made even more reliable by access to cadastral land surveys.⁶⁴ Obviously, it would be unreasonable to assume that a registry of movable collateral would have the same capability by describing movables as, for example, "an inventory comprised of 250 boxes of men's cotton undershirts and 500 hundred unboxed khaki pants located throughout the described enterprise."

As will be recalled, the registration of mortgages of collateral described as "raw materials, semi-manufactured

⁶² LAWINFOCHINA PRL, *supra* note 2, art. 189 (emphasis added).

⁶³ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.I.A.

⁶⁴ *Id.* § 19.I; see BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE] arts. 55a, 873 (Ger.),

http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p3505.

goods and products” is governed by Article 189. This provision requires that the security interest be filed in “the administrative department for industry and commerce” nearest to the debtor’s residence. However, once the interest in an item becomes an account receivable or a promissory note or draft, e.g., upon sale of the product, its security is no longer that of a mortgage, but rather that of a pledge, which is governed by Article 212. And this Article provides that a pledge is perfected by delivery of the collateral to the creditor. The potential for confusion is endless.

To illustrate the difficulties created by this normative discontinuity, NatLaw Research Attorney Rachael Sedgwick analyzed *Shaanxi Provincial Higher People’s Court Civil Judgment Shanmin Erzong Zi No. 00106 of 2014*.⁶⁵ The case illustrates that answers to questions as seemingly basic as “what must be filed, how, and where?” are so numerous and conflicting that the viability of the PRC’s ST law and system of public notice is threatened. In the case in question, the Appellant was Baoji Chencang District Branch of Agricultural Bank of China Co., Ltd. (hereinafter Bank). The Appellee was

⁶⁵ Zhongguo Nongye Yinhang Gufen Youxian Gongsi Baoji Chencang Qu Zhihang Yu Baoji Qin Feng Guoshu Chu Yun Maoyi Youxian Gongsi Jiekuan Danbao Hetong Jiufen Ershen Minshu Panjueshu (中国农业银行股份有限公司宝鸡陈仓区支行与宝鸡秦丰果蔬储运贸易有限公司借款担保合同纠纷二审民事判决书) [China Agricultural Bank Co., Ltd. Baoji Chencang District Sub-branch and Boaji Qinfeng Transportation Co., Ltd. Loan Guarantee Contract Dispute Second Civil Judgment], WENSHU CT. (Shaanxi Provincial Higher People’s Ct. 2014), <http://wenshu.court.gov.cn/content/content?DocID=bfdc398a-c2bb-4ff8-8254-1659e6b6f511&Keyword=%EF%BC%882014%EF%BC%89%E9%99%95%E6%B0%91%E4%BA%8C%E7%BB%88%E5%AD%97%E7%AC%AC00106%E5%8F%B7>.

Baoji Qinfeng Fruit & Vegetable Storage & Transportation Co., Ltd. (hereinafter Qinfeng). The Chencang Bank appealed a trial court's holding that the Bank did not have priority to the movable property mortgaged to the Bank under three Maximum Mortgage Contracts that it had signed with Qinfeng. The appellate court reversed.

The court of first instance established that Qinfeng and Chencang Bank signed sixteen loan contracts worth a total of 23.06 million yuan. Their dispute revolved around the validity of three of the contracts, each secured by mortgages, and whether Chencang Bank had priority to payment from the sale of the properties mortgaged. The court's holding on two of the mortgage contracts will not be discussed, as they involve real property collateral.

The contract submitted to the court contained an article indicating that the properties mortgaged under the contract would be recited in an attached list, but there was no such attachment. The contract in question was a Mortgage for a Maximum Amount on movable assets, including machinery and equipment. Chencang Bank registered this Mortgage in August 1999, September 2000, and December 2000, and subsequently sued to assert its priority. Although the Chencang Bank was not able to submit the original agreement, it had submitted an MRC which it had filed at an office or location that was not specified by the court.

The trial court held that the MRC was not enough to validate the mortgage agreement. It ruled that because Chencang Bank did not have original copies of its movable property mortgage, and there was no list of property attached to the registered mortgage, it could not prove the validity of the Mortgages over the collateral. Thus, Chencang Bank did not have priority over the alleged machinery and equipment

collateral. The court justified the decision by citing Article 206 of the Contract Law and Article 33 of the Guaranty Law.

The Chencang Bank appealed. The Appeals Court reversed the decision and found that, even though there was no list of secured property attached to the Mortgage when it was registered, the validity of the Mortgage was proved by the MRC submitted to the court. Thus, the appeals court held Chencang Bank had priority to the repayment from the proceeds of the sale of the mortgaged property.

Commentary: The translation of this case does not make it clear where the Mortgage was registered. However, three different dates of registration were provided to the court below: August 1999, September 2000, and December 2000. While the absence of discussion of the matter implies that there was no confusion regarding the issue of registration, the fact that the one Mortgage was registered on three dates suggests otherwise.

Indeed, there is great confusion surrounding the issue of mortgage registrations in the PRC. Article 42 of the Guaranty Law is one source of potential confusion surrounding registration matters. The Article provides the filing instructions for each of five different types of collateral: land-use rights, real estate rights, forest and trees, aircrafts and ships and vehicles, and equipment and other movables. Subsection 5 guides registration for equipment and other movables: "If equipment and other movable properties are mortgaged, the registration shall be handled by the local industrial and commercial administration departments."

However, there are many local industrial and commercial administration departments, and they are not fixed entities; instead, they are fluid. Their boundaries change as counties combine or divide to establish and re-establish themselves under new names and geographies, potentially

every few years. For example, in 2010, in the municipality of Shanghai, there were anywhere from 8 to 18 counties in place,⁶⁶ but in 2018, there were 16 counties.⁶⁷ It is not clear how the authority to issue regulations that guide registration is affected by one county's morphing into another.

Scholars have taken note of the issue of numerous registries and potentially competing authorities and proposed solutions. Dean Shoubin Ni and Professor Feiyu Chen, for instance, assert that Shanghai is in the process of developing an exemplary centralized registration system.⁶⁸ Indeed, a centralized system would do a great deal to instill certainty in its users especially when it is not based upon proof of ownership of the collateral. There is also potential for uniformity nation-wide under the State Administration for Industry and Commerce (SAIC).⁶⁹ However, SAIC updates to registration regulations have not necessarily assisted in clarifying matters. To illustrate, the SAIC updated its Chattel Mortgage Registration Procedure Regulation, which took effect on September 1, 2016. Under the new Regulation, those who wish to register a mortgage in movables must register at

⁶⁶ *Administrative Divisions*, SHANGHAI YEARBOOK 2010, <http://www.shanghai.gov.cn/node2/node19828/node82611/node82617/node82625/userobject1ai115500.html> (Feb. 1, 2019).

⁶⁷ DISTRICTS AND COUNTY, SHANGHAI MUNICIPAL PEOPLE'S GOVERNMENT, <http://www.shanghai.gov.cn/shanghai/node27118/node27386/node27406/index.html> (last accessed Feb. 1, 2019 3:14 PM MST).

⁶⁸ Ni & Chen, *supra* note 3, at 163.

⁶⁹ *See, e.g., Mission*, STATE ADMINISTRATION FOR INDUSTRY AND COMMERCE (SAIC), <http://home.saic.gov.cn/english/aboutus/Mission/> (Feb. 1, 2019).

the county level.⁷⁰ This means that a secured creditor would still have to register a single mortgage many times because most Provinces are comprised of many counties, as illustrated in the next paragraph.

Given the confusion that PRC ST laws can create, it is not surprising to find that “[t]he number of new cases received by the courts has continued to rise.”⁷¹ According to the Director of the Supreme People’s Court Judicial Management Office, in the first three months of 2018 alone, Chinese courts heard 4,422,200 trials related to registration issues, with most taking place in the provinces of Henan (85 counties), Jiangsu (19 counties), Shandong (56 counties), and Zhejiang (32 counties), with over 250,000 cases in each of these provinces.⁷² Further, out of the 59,037 cases heard by the People’s Supreme Court, 29.18 percent (or just over 17,226) dealt with real and movable property registration issues.

F. SECURITY INTERESTS AND ECONOMIC DEVELOPMENT:
THE DEVELOPMENTAL IMPORTANCE OF AN OPEN
NUMBER (*NUMERUS APERTUS*) OF SECURITY INTERESTS
AND COLLATERAL.

⁷⁰ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.1.B; MRCHM, *supra* note 34, art. 2.

⁷¹ Zhang Xi, *The Number of Newly-Increased Cases Continued to Increase the Number of Closed Cases Increased Year-on-Year, the Operation Situation is Stable*, PEOPLE’S COURT NEWS MEDIA HEAD OFFICE (May 7, 2018), <https://www.chinacourt.org/article/detail/2018/05/id/3295839.shtml>.

⁷² *Id.*

Principle 3 of the NatLaw 12 Principles advocates the adoption of an open number of movable or personal property collateral options. That principle states:

The security interest may be created in any personal property susceptible to monetary valuation whether present or future, tangible or intangible including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. Thus, personal property collateral as well as security interests in them are open in number (*numerus apertus*), and these security interests are not limited to pre-existing devices such as the pledge, with or without dispossession of the collateral, chattel mortgages, retention of title or conditional sales, etc.⁷³

In contrast, Article 5 of the PRL adopted the opposite principle: "The varieties and contents of real rights shall be stipulated by law."⁷⁴ In support of this principle, Professor Mo Zhang refers to the "well-known civil law principle that governs property . . . that the property rights must be prescribed by law and may not be created by and between the parties. This principle is widely titled in civil law countries as the *numerus clausus*."⁷⁵ He added that this principle is "aimed at excluding the 'autonomy' of the property owner to 'invent' any property interest that is not named or provided by the law and is considered as a substantial limitation on the definition of property [in] . . . the code."⁷⁶

⁷³ See 12 NatLaw Principles, *supra* note 51, at Principle 3.

⁷⁴ LAWINFOCHINA PRL, *supra* note 2, art. 5.

⁷⁵ See Mo Zhang, *From Public to Private: The Newly Enacted Chinese Property Law and the Protection of Property Rights in China*, 5 BERKELEY BUS. L. J. 317, 346-347 (2008).

⁷⁶ *Id.* at 347.

As the reader is well aware by now, this author describes the law of the PRC as an “invertebrate” form of statutory drafting.⁷⁷ One of the few advantages of this type of drafting is that it enables new types of security interests in new types of collateral. According to Article 180 of the PRL:

The following properties to which the obligor or the third party has the right to dispose of may be used for mortgage:

- (1) Buildings and other fixed objects on the ground;
- (2) The right to use land for construction;
- (3) The right to contracted management of barren land, etc. as obtained by means of bid invitation, auction and public consultation, *etc.*;
- (4) Manufacturing facilities, raw materials, semi-manufactured goods and products;

⁷⁷ See the definition of “invertebrate” at *supra* note 40; see generally KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.3.B. The following is a brief excerpt:

The PRC’s law on real property transactions is as legally invertebrate as that of the USSR, if not more so. Not infrequently, a governmental entity is one of the parties to a land dispute, and the presumption since time immemorial is that state rights are superior to those of private parties. And then, there is the division of state and collectively owned land, each with its own legal regime . . . Not surprising, land ownership and use law consists of a bewildering array of often hierarchically-disconnected enactments by central and local legislative, executive and judicial branches of government, including directives or instructions by the national or local congresses to the respective courts on how to interpret constitutional statutory and administrative provisions and vice-versa. *Id.*

- (5) Buildings, vessels and aircraft that are under construction;
- (6) Means of communications and transportation;
- (7) *The properties other than those that shall not be mortgaged according to any law or administrative regulation.*⁷⁸

The above language comes from the *LawInfoChina* translation. The *Lehman, Lee and Xu* translation is more direct and, thus, seems more open to acquiring rights in other collateral. Article 180(7) in the *Lehman, Lee, and Xu* translation reads: "Other property that *may be mortgaged according to law and administrative rules.*" Therefore, both translations open the door to new types of collateral, providing that existing or new laws or administrative regulations (perhaps at the administration of registries level) allow their use. And where pledges are concerned, the *LawInfoChina* and *Lehman, Lee and Xu* translations of Article 223, Section 7 of the PRL agree that other property rights can be pledged if they are allowed, "according to any law or administrative regulation."⁷⁹

i. Fixtures

Presently, PRL Article 180(1) refers to fixtures as "other fixed objects on the ground" occupied by buildings. The implication of this description is that, as another traditional civil law aphorism would have it: "The accessory [movables] always follows the principal [immovables]." In other words, once a fixture is affixed to an immovable, no matter how expensive or useful, it becomes a physically, as well as a legally, inseparable part of it. Yet, this principle is as obsolete

⁷⁸ *LAWINFOCHINA PRL, supra note 2, art. 180 (emphasis added).*

⁷⁹ *Id.* art. 223.

as that which described movable property during the European early middle ages as “vile” property, as in the aphorism “*res mobilis, res vilis.*”

No one conversant with the values of our contemporary financial marketplace would deny that, increasingly, movables, such as state-of-the-art technological equipment encased in fixtures, could be more valuable than many of the buildings to which those fixtures would be affixed. A decade ago or so, I was asked for a legal opinion in a dispute between a supplier of fixtures (which contained highly sophisticated electronic equipment, hardware, and software) to a building, and the bank that financed the construction of the building. As it happened, the market value of the fixtures was higher than that of the building without them. The supplier of the fixtures had filed a financing statement covering goods “that are or are to become fixtures satisfying Section 9-502(a) and (b) of the U.C.C. as well as § 9-604.” It was filed prior to the filing of the real property mortgage in the real property registry by the bank that financed the construction of the building. At the same time, it was filed in the registry of security interests in movable property.

This bank contended that its real estate mortgage should prevail over the fixture filing, assuming, as did Article 180 of the PRL, that as long as those movables had been permanently affixed to the building or the land, the land owner or the mortgagee of the land would prevail over any other security interest in the building’s fixtures. I was of the opinion that the fixture filer, having filed first in the real property as well as in the registry for secured transactions in movable property, should prevail. The parties settled on terms favorable to the fixture filer. This settlement reflected the importance of fixtures to financing the growth of many

industries, including those owned by small- and medium-sized companies.

ii. Contract Rights: The Contract to Manage or Exploit Barren Land and Their Market Value

Please recall that PRL Article 180 requires that collateral be comprised of “properties to which the obligor or the third party has the right to dispose of.” And while this requirement can usually be met by the holders of property rights in the buildings and manufacturing facilities mentioned in Sections 1, 4, and 5 of Article 180, the same is not true for the holders of the rights described by Sections 2 and 3 (i.e., the right to use land for construction, and the right to perform “contracted” management of barren land).

These are not rights of ownership or of disposition (as required by Article 180’s reference to rights “to which the obligor or the third party has the right to dispose of”). Some seem to be the rights of the holder of a PRL *usufructus*. Article 117 of the PRL describes such rights: “A usufructuary right holder shall enjoy the right to possess, use and seek proceeds from the real property or movable property owned by someone else according to legal provisions.”⁸⁰

Please note that this provision does not grant the usufructuary a right to dispose of cultivated land or of the right to cultivate it. Further, Article 184 expressly prohibits their mortgage: “None of the following may be mortgaged: . . . 2) The right to use cultivated land, house sites, land set aside for farmers to cultivate for their private uses . . .” In other words, while an owner of Article 64 “personal” or

⁸⁰ LAWINFOCHINA PRL, *supra* note 2, art. 117 (emphasis added).

“private” urban property may sell that property, rights in contracts on rural land may not be mortgaged or sold.⁸¹

Under PRL Article 184:

The following property may not be mortgaged:

- (i) Ownership of the land;
- (ii) Land-use right to the land owned by the collectives such as cultivated land, house sites, private plots and private hills, with the exception of those provided by law;
- (iii) Educational facilities, medical and health facilities of schools, kindergartens, hospitals and other institutions or public organizations established in the interest of the public and other facilities in the service of public welfare;
- (iv) Property in relation to which the ownership or the right of use is unknown or disputed;
- (v) Property sealed up, distrained or placed under surveillance in accordance with law; or
- (vi) Other property which may not be mortgaged as prescribed by law.⁸²

Yet, PRL Article 133 mentions, in passing, that a contractor (obligor) can mortgage its right to manage barren land as part of its right to “circulate” such rights: “The right to the contracted management of land to barren land or other rural land that is contracted by means of bid invitation, auction, or open negotiation, etc. may be circulated by means of transfer, lease, equity contribution, or mortgage, etc.”⁸³

What rights would such a mortgage convey to its holder-mortgagee, and how valuable are these rights likely to be? According to Article 18(3) of the Law of the People’s

⁸¹ *Id.* art. 184.

⁸² *Id.*

⁸³ *Id.* art. 133 (emphasis added).

Republic of China on Land Contracts in Rural Areas of 2002 (hereinafter LLCR), the grant is made by the villagers' assembly of the collective organization that holds title to it: "in accordance with the provisions of Article 12 of this Law, the contracting plan shall. . . be subject to consent by not less than two-thirds of the members of the villagers' assembly of the collective economic organization concerned or of the villagers' representatives. . . ." ⁸⁴

Clearly, the grantor institution, as well as the rights it grants, are both rural *and contractual* in nature. The Contract Law of the People's Republic of China of 1999 validated the assignment of contract rights by providing that: "The obligee may assign its rights under a contract in whole or in part to a third person, except where such assignment is prohibited: (i) *in light of the nature of the contract*; ii) *by agreement between the parties*; (iii) *by law*." ⁸⁵

This assignment requires that the obligee notify the obligor or risk its unenforceability. ⁸⁶ In addition, as is now typical of the international law on assignment of contract rights, ⁸⁷ under Article 82 and 83 of the PRC Contract Law, the obligor may avail itself of any defense it has against the assignor and may avail itself of any rights of set-off against the assignee. ⁸⁸ Clearly, the availability of these seemingly

⁸⁴ LLCR, *supra* note 15, art. 18(3).

⁸⁵ CONTRACT LAW, *supra* note 16, art. 79.

⁸⁶ *Id.* art. 80.

⁸⁷ UNCITRAL MODEL LAW ON SECURED TRANSACTIONS (U.N. COMM'N ON INT'L TRADE L. 2016), http://www.uncitral.org/pdf/english/texts/security/ML_ST_E_ebook.pdf.

⁸⁸ Compare CONTRACT LAW, *supra* note 16, arts. 82 & 83 and U.N. CONVENTION ON THE ASSIGNMENT OF RECEIVABLES IN INTERNATIONAL

non-waivable defenses against the assignee or purchasers of these contract rights makes these contract rights much less certain and renders their market value unattractive as collateral, unless these rights are waived by the obligor, as allowed by the UNCITRAL Convention on Assignment of Receivables in International Trade,⁸⁹ among other sources.

Also, an assignment without the waiver of these defenses and rights of set-off does not embody a right equivalent to that of a “lawful holder of a negotiable instrument” under the widely adopted Geneva Convention, or of a “holder in due course” under U.C.C. Article 3.⁹⁰ Such a holder is immune precisely to the type of “personal” defense that can be raised by the obligor against the assignee of the land contract right. Even less certain would be the right of an assignee or purchaser of contract rights if these rights would have to compete against those of a secured creditor with a perfected security interest in the proceeds of the assigned contract rights, as provided by the U.C.C. and the OAS Model Law, among other ST laws.⁹¹

TRADE art. 18 (2004), <https://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf> [hereinafter U.N. RECEIVABLES CONVENTION].

⁸⁹ See U.N. RECEIVABLES CONVENTION, *supra* note 88, art. 19.

⁹⁰ See League of Nations Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes art. 16 (1930) for the requirements of a “lawful” holder. See also *id.* art. 17, which states: “Persons sued on a bill of exchange cannot set up against the holder defenses founded on their personal relations with the drawer or with previous holders, unless the holder, in acquiring the bill, has knowingly acted to the detriment of the debtor.” Similarly, see U.C.C. §§ 3-302(1) & (2).

⁹¹ See U.C.C. § 9-309; see also OAS Model Inter-American Law on Secured Transactions arts. 13-20 (2002),

Nonetheless, and despite the uncertain status of an assignee of contract rights in agricultural land, Article 133 of the PRL took the bold step of declaring these rights to be collateral that may be subject to the security interest of a mortgage. This step is bold because the notion of a security interest in contract rights is not an easily acceptable one among civil law countries, as this author can attest after discussing the adoption of this concept with European and Latin American law professors and legislators. Nonetheless, it is a necessary step in making it possible to be able to rely on such collateral, which is important to the life of small- and medium-sized businesses.

As national versions of the OAS Model Inter-American Law of Secured Transactions came into effect in Guatemala, Honduras, and Mexico, I was a witness to the considerable success of several small businesses in Latin America. In one instance, a small farmer who had developed an effective pesticide was able to use his rights in associated sale agreements to two credit cooperatives to receive a line of credit with a bank. This line of credit made it possible for what started as a family enterprise of two workers to develop into a sizeable enterprise that employed three dozen workers in a two-year period. The same result was achieved by a small producer of ice cream, who was able to obtain a supply agreement for his ice cream from a large department store and, using it as contract right collateral, obtained several lucrative lines of credit.

Unfortunately, agricultural land contract rights, under the PRC's LLCR, are not afforded the same certainty. Article

https://www.oas.org/dil/Model_Law_on_Secured_Transactions.pdf
[hereafter OAS MODEL LAW].

26 of the LLCR introduces a significant element of uncertainty, which reflects the attraction that urban employment still holds among rural workers:

If during the term of contract, the whole family of the contractor moves into a small town and settles down there, the right of the contractor to land contractual management shall, in accordance with the contractor's wishes, be *reserved*, or the contractor shall be allowed to *circulate* the said right according to law.⁹²

Simply put, if the contractor-mortgagor of the land right were to move to and settle in a small urban town, he would have the choice of "reserving" the contracted land right or "circulating" his contractual right by "transferring," "selling," "leasing," "exchanging," or "mortgaging" it.⁹³ Then, however, a mortgagee (lender) would be left to wonder what would happen to its loan while the land contract was being held "in reserve" or while the mortgagor was trying to "recirculate it." And, even more disturbingly to a mortgagee, Article 26 of the LLCR also states:

If during the term of contract, the whole family of the contractor moves into a city divided into districts and his rural residence registration is changed to non-rural residence registration, he shall turn his contracted arable land or grassland back to the party giving out the contract. If the contractor fails to turn it back, the party giving out the contract may take back the contracted arable land or grassland.⁹⁴

⁹² LLCR, *supra* note 15, art. 26 (emphasis added).

⁹³ *Id.*

⁹⁴ *Id.*

Unquestionably, the spirit of the LLCR is to encourage the PRC's young, rural population to stay in rural areas by working the land. Nevertheless, this encouragement should not be at the expense of mortgagees (lenders), lessees, sublessees, transferees, "equity" contributors, or other third-party participants in the "circulation" of the rural land mentioned by Article 133 of the PRL.

Clearly, if the PRC continues to need agricultural credit, as we hear it does, such credit would have to be supported by an enabling legal framework that permits the effective utilization of more valuable and easily realizable collateral. Yet, as we have just discussed, this does not seem to be the case, especially with regard to land contractual management rights. Further, the PRL lacks up-to-date, detailed regulation of the most popular and valuable types of collateral associated with agricultural credit: paper-based and electronic documents of title.⁹⁵

G. NEGOTIABLE DOCUMENTS OF TITLE

i. Paper-Based Documents of Title

As apparent in the dispute over aluminum materials in the case between Hao Hao, Yinnuo, and the Bank,⁹⁶ valuable goods deposited in a plant did not become collateral because there were no warehouse receipts that attested to the preferential right to possess those goods by the holder of the receipts. Faced with the need to accommodate new security

⁹⁵ See *infra* notes 102–106 and accompanying text.

⁹⁶ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.I.A.1.c.

interests in new forms of collateral, such as in electronic documents of title, and to provide guidance to courts on conflicting claims against the same movable goods, it became necessary for the U.C.C. to enact provisions such as the U.C.C.'s § 7-502(a). It states: "Subject to Sections 7-205 and 7-503 a holder to which [sic] a negotiable document of title has been duly negotiated acquires thereby: (1) Title to the Document; (2) Title to the Goods"97

Still, how could the mere possession of these "documents of title" in the hands of letter of credit bankers "perfect" their possessory rights against third parties, such as buyers and sellers, or other secured and unsecured creditors? Please note that, if the determining factor for the perfection of rights sold was their "historical" ownership, the "retention of title" by an unpaid seller would prevail over the rights of the bank holder of the documents of title. However, under the U.C.C., perfection of the possessory rights embodied in negotiable documents of title could be effected through a filing of a financing statement or through an endorsement of the negotiable document of title to its holder, either by the issuer of the document, such as the carrier or warehouseman, or by an earlier holder.

Thus, U.C.C. § 9-312(a) provided that perfection by filing (in a secured transactions registry) takes place with respect to *a security interest in chattel paper and negotiable documents among other collateral*.98 In addition, Official

⁹⁷ U.C.C. § 7-502.

⁹⁸ According to Official Comment to U.C.C., *supra* note 18, § 9-102.5(b), chattel paper "consists of a monetary obligation [such as expressed in a promissory note or draft] together with a security interest in or a lease of specific goods. The monetary obligation and security interest or lease are evidenced by a record or records."

Comment No. 3, second paragraph, called attention to the fact that perfection by delivery of negotiable documents (usually by endorsing them to the secured creditor) is a common method of perfecting the security interest in a document of title. It also reminded us that “the secured party’s *taking possession of a tangible document or control of an electronic document will suffice as a perfection step. . .*”⁹⁹

Further, U.C.C. § 9-312(c) provides that, while goods are in the possession of the bailee, warehouseman, or carrier that has issued the negotiable document covering the goods:

- (1) a security interest in the goods may be perfected by perfecting a security interest in the document; and
- (2) a security interest perfected in the document *has priority over any security interest that become perfected in the goods by another method during that time.*¹⁰⁰

Subsection 2 warns that, if a creditor perfects a security interest in the document of title, this perfection prevails over any other perfection in the goods. This means that other asserted secured rights *in rem* to the goods, such as those of the seller who retains title to the goods sold, even though earlier in time, are inferior to the rights of a holder of a perfected security interest in the document of title to the same goods.

The above methods of perfection reflect the existence of several possessory methods of perfection of a security interest in documents of title and goods they cover: in the first, the secured creditor *takes possession of the goods* that would otherwise be covered by the documents of title; in the second, the secured creditor receives from his debtor, or from

⁹⁹ *Id.* § 9-312(a) official cmt. no. 3 (emphasis added).

¹⁰⁰ *Id.* § 9-312(c) (emphasis added).

the latter's warehouseman or carrier, the original document of title endorsed to him and, thereby, perfects his security by receiving possession by endorsement. Alternatively, a third method of perfecting by possession could be used when documents of title issued "to bearer" are allowed, in which case the document of title is delivered to the creditor-bearer without an endorsement. Aside from these possessory security interests, a security interest in documents of title is also frequently perfected by filing the security interest, usually in a registry where the debtor is located.

ii. Electronic Documents of Title

During the last two decades, many documents of title (especially warehouse receipts for the storage of dry agricultural products, such as cotton, wheat, corn, coffee, sorghum, and rice, or industrial goods, such as metals) are being issued electronically in massive amounts in the United States, and in smaller amounts elsewhere.¹⁰¹ They are also being increasingly traded in commodity exchanges for present and future goods in the United States, African, and Asian commodity exchanges.

The reason why the trading world needs these electronic "documents" is simple; the world's population continues to grow, and it needs to be fed by a shrinking group

¹⁰¹ See AJICL Symposium, *supra* note 1, at 178–218, for the following articles: Drew L. Kershen, *Warehouse Receipts in United States Law—Summary for the Pacific Rim*, *id.* at 179; Vassili D. Zhivkov, *Roadmap for the Harmonization of Trans-Pacific Law and Practice*, *id.* at 192; Adalberto Elias, *Recent Electronic Receipts in Mexico*, *id.* at 199; and Ari M. Pozez, *A Roadmap to Better Understanding the Issuance and Transfer of Negotiable Electronic Warehouse Receipts in the American Cotton Trade*, *id.* at 205.

of agricultural nations, as many former large producers of agricultural goods have chosen to industrialize at the expense of their agriculture. This requires that nations that are interested in supplying agricultural products to others do so as safely, quickly, and inexpensively as possible, especially when their agricultural products are “dry” and can be warehoused and sold while they are still marketable.

In addition, the millennial practice of issuing two documents of title for the same stored goods—a certificate of deposit given to the depositor of the goods and a pledge bond transferred or endorsed to the secured creditor—has proven highly vulnerable to massive fraud, largely because both documents are in the hands of different holders; one supposedly holding title to the goods and the other holding a preferential possessory right in the same goods as a secured creditor. China, among other major markets, has been a victim of this massive (in the billions of dollars) fraud.¹⁰² In

¹⁰² See *Mercuria v. Citi: High Court Rules on Qindao Warehouse Financing Case*, CLYDE & CO. (June 18, 2015), <https://www.clydeco.com/insight/article/mercuria-v-citi-high-court-rules-on-qingdao-warehouse-financing-case>, for the following reference to the first important English decision:

The first significant decision from a non-Chinese court on one such claim was delivered by Mr. Justice Phillips in the English High Court, on 22 May 2015, in the case of *Mercuria Energy Trading Pte. Ltd. and another v Citibank NA and another* [2015] EWHC 1481 (Comm). The focus of the dispute was the operation of “repo agreements” (repurchasing agreements) under which Mercuria sold metal that it had purchased from Decheng to Citibank NA on the basis that Citi would re-sell the same or equivalent metal back to Mercuria at an agreed future date, at a fixed higher price, the difference in the price being, in effect, the cost of the finance. These repo agreements were subject to

contrast, electronic warehouse receipts, as unitary “records,” are much safer and faster to issue, sell, and use as collateral. When electronic warehouse receipts are issued and traded, the secured creditor acquires another form of possession of electronic documents of title, labeled by the U.C.C.¹⁰³ and the UNCITRAL Model Law of International Electronic Transferable Documents as “control.”¹⁰⁴

According to U.C.C. § 7-106(a): “A person has control of an electronic document of title if *a system* employed for evidencing the transfer of interests in the electronic document reliably establishes that person as the person to which [sic] the electronic document was issued or transferred.”¹⁰⁵ Section (b) sets forth the features that would qualify a computerized system for the transfer of security interests in electronic records acceptable:

English law and the jurisdiction of the High Court in London. The judgment contains a useful discussion on potential problems in the drafting of repo agreements, but it also covers points of more general application to the sale of goods and warehouse financing.

See also, Warehousing: The Biggest Warehouse Frauds of Recent Times, FASTMARKETS MB (Dec. 6, 2017 10:00 AM GMT) <https://www.metalbulletin.com/Article/3768844/WAREHOUSING-The-biggest-warehouse-frauds-of-recent-times.html>.

¹⁰³ UNIFORM ELECTRONIC TRANSACTIONS ACT § 16 (NAT’L CONF. OF COMM’RS ON UNIF. ST. L. 1999), <http://euro.ecom.cmu.edu/program/law/08-732/Transactions/ueta.pdf>. *See also* U.C.C. § 7-106 (AM. LAW INST. & UNIF. LAW COMM’N 2003).

¹⁰⁴ UNCITRAL MODEL LAW ON ELECTRONIC TRANSFERABLE RECORDS art. 11 (U.N. COMM’N ON INT’L TRADE LAW 2018), http://www.uncitral.org/pdf/english/texts/electcom/MLETR_ebook.pdf.

¹⁰⁵ U.C.C. § 7-106(a) (emphasis added).

A system satisfies section (a) and a person is deemed to have control of an electronic document of title, if the document is created, stored, and assigned in such a manner that:

(1) a single authoritative copy of the document exists which is unique, identifiable and except as otherwise provided in paragraphs (4) (5) and (6) inalterable¹⁰⁶

Please note that the method required for this type of control is by creating an electronic document and transferring a single, unique, and reliably identified, authoritative copy, i.e., the electronic document itself. Such a system is in the process of being developed by public and private entities throughout the trading world, including by NatLaw and Mexico's Ministry of the Economy.¹⁰⁷ Meanwhile, if the security interest and its electronic record can satisfy the requirements for the creation of a security interest in the document of title as an "enlarged" version of chattel paper under § 9-102(5)(b), existing versions of software *may* enable not only the transfer of the single, unique, and authoritative copy of the document of title, as envisaged by U.C.C. § 7-106, but also the filing of the perfected security interest in the electronic document of title.

H. THE EXTRA-JUDICIAL ENFORCEMENT OF THE GENERAL MORTGAGE

Having established the rights that a mortgagor/debtor is expected to convey in order to create a valid General

¹⁰⁶ U.C.C. § 7-106(b).

¹⁰⁷ Marek Dubovec & Adalberto Elias, *A Proposal for UNCITRAL to Develop a Model Law on Warehouse Receipts*, 22 UNIF. L. REV. 716 (2017).

Mortgage under the PRL, the U.C.C., and other influential laws, it is time to examine the rights that the PRL confers upon the mortgagee when attempting to enforce its perfected security interest. Do these rights allow the mortgagee, once the debtor defaults in its obligation of payment, to repossess, retain, or dispose of the mortgaged property only judicially, or can it also enforce these rights extra-judicially? In describing these powers, Article 179 of the PRL uses highly measured remedial language: “[The mortgagee] shall be entitled to seek preferred payment.” This formulation does not state that the secured creditor shall be entitled to repossess the movable property if the parties had so agreed, as stated, for example, by Article 62 of the OAS Model Inter-American Law of Secured Transactions and by Article 62 of Colombia’s *Ley de Garantías Mobiliarias* (Secured Transactions Law).¹⁰⁸

¹⁰⁸ See OAS MODEL LAW, *supra* note 91, art. 62, which states:

At any time, before or during the enforcement proceeding, the debtor may reach an agreement with the creditor on terms other than those previously established, either for the delivery of the goods, the terms of the sale or auction, or any other matter, provided that said agreement does not affect other secured creditors or buyers in the ordinary course of business.” National versions of this law have been adopted in 9 Latin American countries.

Colombia’s *Ley de Garantías Mobiliarias*, or *Ley 1676 del 20 de Agosto de 2013* [Secured Transactions Law],

<http://wsp.presidencia.gov.co/Normativa/Leyes/Documents/2013/LEY%201676%20DEL%2020%20DE%20AGOSTO%20DE%202013.pdf>, has been one of the most successful, and its *Artículo 62*, a translation of which follows, has been influential in the versions adopted by other Latin American countries:

The special execution of STs shall be available in any of the following situations: 1.) By agreement between the secured creditor and debtor as part of the security agreement or its

Nor does it state that the secured creditor may proceed to repossess the collateral "without judicial process if [it] proceeds without breach of peace," as is allowed by Article 9 of the U.C.C.¹⁰⁹

Article 186 of the PRL reveals the reasons for Article 179's modest remedial allowance to the secured creditor: "A mortgagee shall not stipulate with the mortgagor that the ownership of the property under mortgage will be transferred to the obligee when the obligor fails to pay its due debts."¹¹⁰ This prohibition addresses an extra-judicial remedy, similar to that of the *Pactum Commissorium* of Roman Law and the German fiduciary transfer of ownership to the secured creditor known as *Sicherungsübereignung*. As noted by a German law practitioner at a major international law firm, the security transfer agreement transfers full legal ownership of the assets to the secured creditor. Like the security

future amendments or agreements. This agreement may include a special mechanism to carry out the sale or appropriation of the collateral, and for this reason shall comply with the provisions related to contract of adhesion and abusive clauses set forth in Colombia's Consumer Protection Statute. 2.) When the secured creditor is in possession of the collateral. 3.) When the secured creditor is entitled to the right of retention of the collateral. 4.) When the collateral is valued at less than 20 minimum monthly legal salaries. 5.) When a stipulated time for performance has come or when the time of effectiveness of a contractual condition subsequent has arrived, as long as the possibility of a special execution was foreseen. 6.) When the goods involved are perishable.

Please note that neither the OAS Model Law, nor the Colombian law prescribe the creditor's acquisition of a right of ownership.

(Author's translation).

¹⁰⁹ U.C.C. § 9-609(b)(2).

¹¹⁰ LAWINFOCHINA PRL, *supra* note 2, art. 186.

assignment, the security transfer is not specifically set out in German law provisions, but it is based on general civil law principles and steady case law.¹¹¹

The following English translation of another *Sicherungsübereignung* prohibition of extra-judicial remedies in another civil law country that, like the PRC, has modeled some of its provisions on German law provides:

The provision of the contract regarding fiduciary transfer of ownership right stating that the property subject to this right shall be definitely transferred to the creditor's ownership if his claim is not satisfied when due, without previously implemented procedure envisaged by this law, shall be null and void, as well as the provision allowing the creditor to use the encumbered property, collect fruits of the property or exploit the property in another manner.¹¹²

It is important to note that this type of prohibition is becoming obsolete. Moreover, far from reflecting a predilection for creditors' rights, the extra-judicial remedies provided by the OAS Model Inter-American Law, the

¹¹¹ See Mattias von Buttlar, *Bank Finance and Regulation Multi-Jurisdictional Survey: Germany: Enforcement of Security Interests in Banking Transactions*, CLIFFORD CHANCE 2 (2018), <https://www.ibanet.org/Document/Default.aspx?DocumentUid=BA60C158-9095-47EA-B3E9-1F28C6012298>. For a thorough examination of the *Sicherungsübereignung* in German Law, see PETER DERLEDER, KAI-OLIVER KNOPS & GEORG HEINZ, *HANDBUCH ZUM DEUTSCHEN UND EUROPÄISCHEN BANKRECHT* § 30 (2009) (Springer, Berlin & Heidelberg eds., 2009).

¹¹² See Law on Fiduciary Transfer of Ownership Right of the Republic of Montenegro, Official Gazette NO.23/96 (1996), <http://www.gov.me/files/1145443221.pdf>. I have selected the English translation of this law over other translations of the German *Sicherungsübertragung* because of its clarity and precision.

Colombian Secured Transactions Law, and U.C.C. §§ 9-609 and 9-610 (among many others) reflect the need to act as quickly as reasonably possible to preserve the market value of perishable collateral for the benefit of both good faith secured creditors and their debtors.¹¹³ It should be remembered that, as a rule, the same laws that enable reliance on these extra-judicial remedies preserve the debtors' rights to sue the abusive creditors for their unjust enrichment or bad faith practices.

III. THE PLEDGE

A. WHAT IS A PLEDGE?

As set forth by Article 208 of the PRL:

An obligor or third party may, for the security of the payment of the debts, pledge his movable properties to the obligee for possession, and when the obligor fails to pay due debts, or any circumstance for realizing the right of pledge as stipulated by the parties occurs, the obligee shall be entitled to seek preferred payment from the said movable properties. The debtor or third party as prescribed in the preceding paragraph shall be the pledger, the obligee shall be the pledgee, and the movable properties as delivered shall be the pledge.¹¹⁴

Thus, unlike the Article 179 General Mortgage, the obligor/debtor of a pledge will transfer possession of the pledged goods or assets to the secured creditor/pledgee.

¹¹³ See OAS MODEL LAW, *supra* note 91, and Colombia's Secured Transactions Law, *supra* note 108.

¹¹⁴ LAWINFOCHINA PRL, *supra* note 2, art. 208.

Also, unlike Article 179 and 180 of the PRL, the pledged collateral consists only of movable goods. But, as with Article 179, if the debtor defaults, the pledgee creditor will not be able to retain or resell the collateral on its own. It shall have to resort to a judicial remedy that will entitle it “to enjoy priority of having his claim satisfied with the proceeds of an auction or sale of the pledged property.” As does Article 186 for the General Mortgage, Article 211 confirms that: “Before the time limit for paying debits expires, the pledgee and pledger shall not stipulate that the ownership of the pledge be transferred to the obligee when the obligor fails to pay due debts.” Presumably, *a contrario sensu*, following default, the parties can agree to an extra-judicial remedy.

B. WHAT COLLATERAL CAN BE PLEDGED? THE SCHISM BETWEEN MORTGAGED AND PLEDGED COLLATERAL

According to Article 223 of the PRL:

The following rights which an obligor or third party has the right to dispose of may be pledged:

- (1) Money orders [perhaps bills of exchange], checks, and cashier’s checks;
- (2) Securities and deposit receipts;
- (3) Warehouse receipts and bills of lading;
- (4) Transferable fund units and stock rights;
- (5) Exclusive trademark rights, patent rights, copyrights or other property rights in intellectual property that can be transferred;
- (6) Account receivables; and

(7) Other property rights that can be pledged according to any law or administrative regulation.¹¹⁵

Please note that the collateral listed above is comprised of rights to documentary as well as intangible or incorporeal property. It must be emphasized that, consistent with the nature of the pledged collateral, none of the corporeal, tangible goods and real property listed in Article 180 as the collateral of general mortgages can be pledged. Conversely, none of the above-listed financial instruments (negotiable instruments and documents of title and investment securities) nor intellectual property can be mortgaged. What would happen, for example, with a mortgage of the “inventory, accounts receivable *including negotiable instruments such as promissory notes, drafts and checks*”? Would it be sufficient to file such a mortgage in the Registry of Mortgages, even though what occurred was a pledge of the documents and instruments listed as pledgeable under the PRC pledge law? Clearly, there appears to be a schism between these two types of security interests.

This schism between property that can and cannot be mortgaged and pledged seriously complicates the use of “continuing” security interests in the “natural” sequences of business assets used as collateral. As discussed earlier in connection with security interests in inventory, accounts and other proceeds,¹¹⁶ many of these cycles start out with a business buying its inventory of goods for resale or a manufacturer acquiring equipment to transform raw materials into finished products. By listing immovable and

¹¹⁵ LAWINFOCHINA PRL, *supra* note 2, art. 223.

¹¹⁶ See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.I.A.4.

movable property items as part of separate and distinct security interests, such as that of the mortgage and the pledge, and by requiring different methods of perfection, the PRL renders financing of the acquisition of raw materials, equipment, fixtures, and inventory much more difficult and expensive than it ought to be.

For example, Article 189 of the PRL requires that when: an enterprise, individual, industrial and commercial household . . . mortgages any of the movable properties 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.¹¹⁷

In contrast, Article 212 of the same law states: “The right of pledge shall be established after the pledgee [sic; pledgor] has transferred the pledge.”¹¹⁸ Yet, as will be recalled, when describing the collateral of a General Mortgage, Article 180 does not mention the “revolving” and renewing type of collateral known as “inventory” except, perhaps, in a vague and imprecise manner.

C. THE CREATION AND THE PERFECTION OR EFFECTIVENESS OF THE PLEDGE

Article 210 of the PRL provides, in relevant part, that: “For the creation of the right of pledge, the parties concerned shall conclude a contract on the right of pledge in written form.”¹¹⁹ And, as just noted, Article 212 “establishes” or

¹¹⁷ LAWINFOCHINA PRL, *supra* note 2, art. 189.

¹¹⁸ *Id.* arts. 208, 212. The *LawInfoChina* translation mistakenly referred to the pledgee as the pledgor. *See id.*, *supra* note 2, arts. 208 & 212.

¹¹⁹ *Id.* art. 210.

perfects the pledge by means of the transfer of possession of the movable collateral listed in Article 223. Yet, some pledged goods may be “pre-registered,” such as investment “fund units or stock rights.” Article 226 provides that:

Where portions of funds and/or shares that have been registered with the relevant security registration and settlement authority are pledged, the right of pledge shall become effective upon registration *with the securities registration authorities*. Where shares of any other kind are pledged, the right of pledge shall become effective upon registration *with the administrative department in charge of commerce*.¹²⁰

Similarly, according to Article 227: “Where the right to exclusive use of trademarks, the property rights among patent rights and copyrights are pledged, the pledgor and the pledgee shall conclude a contract in writing. The right of pledge shall become effective upon registration with *the administrative department in charge of commerce and industry*.”¹²¹ And where the right of collecting receivables is pledged, Article 228 prescribes that the pledgor and the pledgee “shall conclude a contract in writing, and the right of pledge shall become effective upon registration *with the competent authority*.” It is precisely this invertebrate style of drafting that has, according to several PRC participants of the Shanghai colloquium, led to endless lawsuits. Please recall NatLaw’s Rachael Sedgwick’s research (discussed above) and how it amply confirms those participants’ impressions; in the first

¹²⁰ *Id.* art. 226 (emphasis added).

¹²¹ LEHMAN, LEE & XU PRL, *supra* note 2, art. 227 (emphasis added).

three months of 2018, Chinese courts heard 4,422,200 trials related to registration issues.¹²²

As if this were little, the PRL has no provisions on the electronic registries for pledges of the above-mentioned negotiable instruments and documents of title, whose perfection is increasingly achieved by means of the concept of “control” (discussed briefly above with respect to electronic documents of title).

D. THE “SPECIAL CASE” OF THE PLEDGE OF RECEIVABLES

Accounts receivable are intangible goods, even if embodied in bills or invoices. What is being used as collateral is the right to collect on records or documents, which indicate that the amounts they refer to have been earned by the contractual performances of those who assigned or sold the accounts to third parties acting as lenders or purchasers and generically designated as assignees. The question remains, however, whether the PRL and the registry of secured transactions will be a sufficiently supportive legal platform for future financing by lenders other than official banks, or whether uncertainties similar to those observed with the land use rights and generic mortgages will plague the commercial and consumer credit life of the PRC. In my 2007 conversations with Central Bank officials, they expressed the hope that accounts receivable financing be less dependent upon central

¹²² Zhang Xi, *The Number of Newly-Increased Cases Continued to Increase, the Number of Closed Cases Increased Year-on-Year, the Operation Situation is Stable*, PEOPLE’S COURT NEWS MEDIA HEAD OFFICE (May 7, 2018 20:31:32 CST), <https://www.chinacourt.org/article/detail/2018/05/id/3295839.shtml>.

bank support and become self-sufficient and help the growth of the riskier “small” businesses. Still, Article 228 of the PRL, one of the PRL’s key provisions on accounts receivable lending, preserves riskiness by stating, in relevant part, a non-answer to the question, where to register? “With the competent authority”:

Where the right of collecting receivables is pledged, the pledgor and the pledgee shall conclude a contract in writing and the right of pledge shall become effective upon registration with the competent authority.

The right of receivables collection, once it is pledged, shall not be transferred unless otherwise agreed by the pledgee and the pledgor. The proceeds from the transfer of the right shall be used to pay in advance the pledgee’s claims secured or be deposited with a third party.¹²³

The first paragraph of Article 228 contains a rule that is at odds with that of model secured transaction laws and their statutory progeny, such as, for example, that of the Organization of American States Article 5: “A security interest is created by contract between the secured debtor and secured creditor.”¹²⁴

In addition, as pointed out by Professor Ronald C.C. Cuming, one of the world’s authorities in ST law, who had the opportunity to evaluate the state of the PRL in a 2013 speech to the People’s Supreme Court: “There are no priority rules applicable to the pledge of accounts receivable that would

¹²³ LEHMAN, LEE & XU PRL, *supra* note 2, art. 228 (emphasis added). The other two translations of the PRL refer to a credit information or credit rating body rather than to a “competent authority.” See LAWINFOCHINA PRL, *supra* note 2, art. 228; see also NPC PRL, *supra* note 2, art. 228.

¹²⁴ OAS MODEL LAW, *supra* note 91, art. 5.

replicate those in Article 189 for generic mortgages.”¹²⁵ He suggested that “the principles, applicable to mortgages of tangible property, with appropriate modifications” should also apply to pledges.¹²⁶ According to Professor Cuming, this would require that: a) a pledge of accounts be valid between the creditor and debtor without registration; b) pledges of existing and future accounts of the debtor be also valid; c) the pledges could secure all the amounts of debt agreed to by the parties while the pledge agreement is valid; d) the priority of the security rights be based on the date of their registration; and e) a security agreement providing for a mortgage on tangible property could also include a pledge of the debtor’s accounts.¹²⁷ I would add that, consistent with the absence of a right to proceeds in the PRL security interests, it would be necessary to clarify that the rights in the accounts also carry-over to the traceable proceeds; thus, a filing as to “accounts” automatically would extend to proceeds.

E. THE EXTRA-JUDICIAL REMEDY OF A PLEDGEE’S LIEN

Article 230 unequivocally confers a lien on the pledgee if the debtor defaults in his debt: “If a debtor defaults in his debt, the creditor shall be entitled to retain the property under legal possession and to the priority of having the debt paid with the money converted from the property or proceeds from the sale or auction of the property.”¹²⁸ Article 236

¹²⁵ See Ronald C.C. Cuming, e-mail comments of October 8, 2013 (on file with the author) (hereinafter “Cuming e-mail”).

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ See LEHMAN, LEE & XU PRL, *supra* note 2, art. 230.

provides that the lien holder and the debtor shall reach an agreement after the time limit for the debtor's performance of its obligations after the property is retained. In the absence of any agreement or any explicit agreement thereof, the lien holder shall grant a time limit of two (2) months or more for the debtor's performance of obligations, except in the case of movables such as fresh, living, and easily decayed goods. If the debtor defaults within the specified time limit, the lien holder may, with the debtor's agreement, sell the retained property or enjoy the priority of having the debt paid with the proceeds of the sale or auction of the property. Market prices shall be used as reference in conversion and sale of the retained property.

It is true that Article 230 of the PRL provides that when a pledgor-debtor defaults, the creditor shall be entitled "*to retain the property under legal possession and to the priority of having the debt paid with the money converted from the property or proceeds from sale or auction of the property. . . .*"¹²⁹ Yet, the remedy of creditor retention presupposes that the secured creditor is already in possession of the collateral, as required by Articles 208 and 212. It is also true that Article 232 allows the parties to agree that the collateral "shall not be retained" by the creditor,¹³⁰ but such a statement falls considerably short of allowing the pledgor-debtor to transform, manufacture, sell, or exchange the raw materials, inventory, or other assets acquired with the secured creditors loan and then, with the proceeds of the sale or exchange, repay it. Please recall that a "perfection" "gap" or "schism" exists between security interests in corporeal or tangible

¹²⁹ *Id.* (emphasis added).

¹³⁰ *Id.* art. 232.

collateral subject to a mortgage, such as raw materials or equipment, and their “transformation” into intangible collateral, such as negotiable instruments subject to a pledge. As a result of the failure to enable the creditor’s quick liquidation of the assets whose acquisition, manufacture, or transformation it facilitated by means of the mortgage, the PRL renders a loan secured by personal property collateral, especially in corporeal or tangible goods, highly uncertain. Further, one gets the impression that the legislators wanted to link the secured creditor’s priorities and remedies, not to what was recorded in a secured transactions registry (including its recording of an earlier priority right), but to the date of an unrecorded right of retention, even if that date was later than the date of the filing of a perfected security interest. Consider, for example, the following priority rule of Article 239:

Where the movable property that [had] . . . already been mortgaged or pledged are retained at a later time, the lien holder shall enjoy the priority of having the debt paid with the money (obtained) from the property or proceeds from sale or auction of the property.¹³¹

Let’s say that secured creditor “One” obtained a generic mortgage without the debtor “D’s” dispossession of equipment “X” and filed its security interest in X in the appropriate secured transactions registry on April 1, 2013. On May 1, 2013, D, while in possession of X conveyed it to secured creditor “Two,” who took possession of X and retained it as its pledge, eventually sold it, and paid itself the unpaid amount of its loan to D, even though the loan and security interest were created and perfected at a later time

¹³¹ *Id.* art. 239.

than that of secured creditor One. Creditor One's registered rights were subordinated to the possession subsequently acquired by Two, thus rendering registration meaningless. Predictably, not much secured lending based upon the priority rules of generic mortgages and pledges in intangible goods can be expected unless the system of priorities is made "continuous" in a fair and cost-effective manner to all the participants in the above described credit transactions.

IV. FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

A. FINDINGS

The preceding analysis exposes many serious problems with the present text of the PRL. First, "secret liens" (such as unregistered sales with retention of title in the seller) coexist with registered security interests, such as mortgages and pledges. Second, the PRL requirement of ownership or "the right to dispose of movable property" to create a security interest is inconsistent with the vast majority of commercial goods, which cannot be identified by individual features, such as serial numbers. Third, the requirement of a "*numerus clausus*" of security interests, as evident in the listing of property that cannot be mortgaged or pledged (Articles 180(7) and 209 of the PRL) is, as discussed, an especially serious problem. This requirement prevents reliance on typical commercial goods, such as revolving and cumulative inventory and proceeds, as well as fixtures that are valuable enough to be mortgaged independently from related immovables. Fourth, the extensive decentralization of the registry system and the absence of a uniform and unified electronic platform creates enormous uncertainty with the perfection and priority of security interests, as proven by the

unsustainable volume of judicial disputes. This uncertainty deprives collateral of “lendable value” when that collateral is in the form of inventory, and its “transactional” successors such as contracts that are still unperformed and accounts that result from performed contracts, and, finally, with the generic type of collateral known as proceeds or assets attributable to the sale, exchange or rental of the previously enumerated collateral.

Fifth, the continuous reliance on an inherently uncertain, “invertebrate” legislative language renders the PRC’s ST system similarly unpredictable and dysfunctional. This language is found, *inter alia*, in enumerations of property that may or may not be collateralized. Accordingly, on the one hand, a rule may indicate that the number of security interests and collateral is closed, and, on the other hand, it may state that other unspecified laws or administrative regulations may allow additional security interests and collateral (see, for example, PRL Articles 117, 133, and 184).

Sixth, one finds directly contradictory laws at times govern the same topic, such as in the Guaranty Law of 1995 and in the PRL. Recall, for example, the disparity regarding the requirement of good faith between Article 188 of the PRL and Article 43 of the Guaranty Law. On the other hand, where symmetrical rules are required for, say, rights of priority in general mortgages and pledges, Professor Ronald C.C. Cuming points to the presence of priority rules for general mortgages but not for pledges. Finally, in addition to the decentralization of the PRC’s registry system pointed out by Dean Shoubin Ni and Feiyu Chen in the Introduction, Rachael Sedgwick, a Research Attorney with NatLaw, has found that

the sheer volume of litigation may threaten the viability of the PRC's ST registration system.¹³²

B. CONCLUSIONS AND RECOMMENDATIONS

The preceding findings lead to the conclusion that the PRL is in need of serious revision, especially in the following areas:

i. Clarification of the Scope of the PRL

The PRL needs to become the sole ST law of the PRC. It should abandon its parallel governance of real and movable property mortgages, whose transactional, conceptual, and registry components are significantly different and, at times, contrary to those of movable property secured transactions. Similarly, the PRL must absorb, update, and unify the provisions on the creation, perfection or effectiveness, priority, and judicial and extra-judicial enforcement of rights in movable property collateral. Currently, such provisions are found in at least half a dozen laws, including, prominently, the aforementioned Guaranty Law of 1995, the Law on Land Contracts in Rural Areas, the Contract Law of 1999, as well as any other laws that contain provisions on the creation, perfection, priority, and enforcement of rights in movable property.

ii. Conceptual Refinement

¹³² See KOZOLCHYK, *COMPARATIVE COMMERCIAL CONTRACTS*, *supra* note 13, § 19.II.B.3 and accompanying text.

The following concepts need to be adopted and refined by eliminating “invertebrate” legislative language, as illustrated in the above findings.

a. Establish a Numerus Apertus Approach to Collateral

It should be clear that the revised PRL will apply to all present and future security interests in movable property and that any property or goods whose traffic is not proscribed by penal laws can be collateral.

b. Provide a Clear Distinction Between the Creation and the Perfection of the Security Interest

Dean Shoubin Ni and Feiyu Chen’s distinction of the creation of the security interest based on what the parties agreed to in their security agreement, should be enforceable between the contracting parties. This act of creation, and its consequences, should be distinguished from the acts of perfection or effectiveness of the security interest by means of the secured creditor’s possession of the collateral or by the filing of a summary of the security interest in the appropriate registry.

The refinement also applies to the functions of the security agreement and the summary financing statement. As noted in the preceding sections, the filing of a security agreement in the registry of security interests in movable property is inconsistent with the function of such a registry. Its notice will be effective when measured against the information needed by a *bona fide* reasonable secured creditor or purchaser of the goods mortgaged or pledged.

c. Distinguish Between a Line of Credit and a Mortgage for a Maximum Amount

As discussed in an earlier section,¹³³ the Line of Credit Agreement is a much more effective device to provide credit, especially to small- and medium-sized merchants or companies, than the PRL's Mortgage for a Maximum Amount. Thus, it should be included and defined carefully, so that it can interact with the definitions of inventory, accounts, and proceeds.

d. Re-Define Highly Liquid, Contemporary Types of Collateral

Among the highly liquid present-day collateral that is not defined or improperly defined by the PRL are: inventory, contract rights, proceeds, and documents of title, particularly electronic ones.

e. Revise the Function and Organization of the Registry of Security Interests

Aside from the helpful recommendations by Dean Shoubin Ni and Feiyu Chen concerning the need for a centralized, unique electronic registry platform, it should be kept in mind that the mission of these registries and their software is not to determine the ownership of the collateral. Registries of ownership of valuable movable property are usually helpful with respect to highly valuable movables such as vehicles, including airplanes, ships or railroads, their

¹³³ See *id.* § 19.I.A.2, and accompanying text.

engines or motors, construction equipment, etc. Their data may be used in the filing of a financing statement by interconnecting their respective registries (of ownership and security interests). In addition, as suggested by Dean Shoubin Ni and Feiyu Chen, the ST registry should be centralized and its data should be easily accessible from anywhere in the PRC and the trading world. I would also add that, based on what NatLaw has learned from its work in Latin America, this technology should be made fraud-proof by the use of emerging technologies such as “Blockchain,” as adapted to centralized public registries.

f. Enable Reliance on Both Judicial and Extra-Judicial Remedies

As shown by the reliance on fair and effective extra-judicial remedies, they are indispensable for secured loans involving quickly perishable goods. By preventing their good faith use by secured creditors, the PRL is augmenting considerably the individual and social costs of secured lending. As the experience of Western Hemisphere countries has shown, unfairness and abuse can be minimized by providing not only the extra-judicial remedies for the extra-judicial sale of the collateral, but also by providing judicial actions against the abuse of such remedies.

