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CHINESE REAL ESTATE MORTGAGE LAW

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Abstract: This Article reviews the developing Chinese law pertaining to real estate mortgage loans with a focus on the questions that an American practitioner might have about the Chinese system. It identifies those areas of difference between the American and Chinese systems that might raise concerns for an American practitioner. Attention is given to issues of concern both to parties functioning as lenders and to parties functioning as borrowers or investors in mortgaged property.

Although Chinese lawmakers have made major steps in recent years to provide clarity and predictability in the laws pertaining to mortgages, some of these laws have minor internal conflicts. In addition, these laws establish protected interests for mortgagees or for lessees that would be viewed in the American legal system as impediments to open market operation. One area of acute concern is the uncertainty as to the parties' ability to alter through contract the operation of Chinese laws affecting the mortgage relationship. Despite the provisions of the new Contract Law promoting freedom of contract, other specific provisions in mortgage-related laws lead to uncertainty as to the flexibility of Chinese law for parties to a mortgage contract.

Also examined is the tendency of Chinese mortgagees to rely less heavily on their security interest mortgages than Western lenders. This is due in part to uncertainty regarding the value of Chinese real estate in general, but also because of uncertainty regarding the enforcement of Chinese mortgage and foreclosure laws. Greater adherence to the rule of law will lead to greater reliability of mortgages, which in turn will make capital more available to Chinese real estate investors.

The conclusion addresses the major areas of concern remaining in the Chinese legal framework. These include the mortgagee's rights to control transfer of the mortgaged property and to collect rents prior to default, an apparent inhibition on lending funds for construction purposes, the special protections against the mortgagee given to lessees, and the mortgageability of leaseholds in general.

I. INTRODUCTION

Real estate mortgages are a favored means of securing large loans in America, especially long-term loans, even when the purpose of the loan has little or nothing to do with the real estate. In the well-established American real estate market, a lender will view the real estate as having an intrinsic value that is likely to persist even when the borrower's business has collapsed and even when economic factors have devalued many of the

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borrower's other hard assets. The lender can readily capitalize on that value either by foreclosure auction or, if the lender must buy at the auction, by reselling the property on the market.

Through various ups and downs in the economy over America's modern economic history, American real estate laws have achieved a rough balance between protecting the lender's expectations, which encourages lenders to make real estate mortgage loans, and protecting borrowers from overreaching lenders, which encourages parties with land to offer the land for mortgage. The triumph of America's modern housing economy is based largely upon the certain value of the American home mortgage. To a lesser but still significant extent, the mortgage device has been the mainstay of American commercial and industrial finance as well.

When a lender considers a Chinese mortgage, however, questions arise that are not likely to even be considered in a Western lending context. China's real estate economy is not mature. Private ownership of real estate interests was virtually non-existent prior to 1988.¹ Since then, the Chinese government has increasingly focused on the sale of granted land use rights²

¹ In 1988, as part of a general government effort to commodify the productive economy and to establish market transactions as a means of resource distribution, China amended its constitution to permit the transfer of land use rights. *Zhonghua Renmin Gongheguo Xianfa Xiuzhengan* [Amendment to the Constitution of the People's Republic of China] (adopted Apr. 12, 1988) art. 2, translated in LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1987-1989 3 (1990) [hereinafter LAWS OF THE PRC, 1987-1989]. The new language provides, "[n]o organization or individual may appropriate, buy, sell, or unlawfully transfer land in other ways. The right to the use of land may be transferred in accordance with the law." *Id.*

² Granted land use rights (*churang tudi shiyong quan*) are urban land use rights granted by the state for a specific period and may be transferred, leased, or mortgaged. See *Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang he Zhuanrang Zanzing Tiaoli* [People's Republic of China Tentative Regulations on the Granting and Transfer of State-owned Urban Land Use Rights] (issued May 24, 1990) [hereinafter 1990 Regulations on Granting Land Use Rights], reprinted and translated as PRC, Granting and Assigning Leaseholds in State-owned Land Tentative Regulations, in 4 CHINA L. REFERENCE SERVICE (Asia L. & Practice) Ref. No. 4100/90.05.24 (1997) [hereinafter 4 CHINA L. REFERENCE]; *Zhonghua Renmin Gongheguo Chengshi Fangdichan Guanlifa* [People's Republic of China, Administration of Urban Real Estate Law] (adopted July 5, 1994) [hereinafter Urban Real Estate Law], reprinted and translated as PRC, Administration of Urban Real Property Law, in 4 CHINA L. REFERENCE, *supra*, Ref. No. 4110/94.07.05 (1997). The Urban Real Estate Law authorizes land administration bureaus at the city or county level to sign contracts granting land use rights. *Id.* art. 14. To acquire a granted land use right, a party must pay a fee to the government for the right itself. *Id.* art. 15.

Granted land use rights should be differentiated from allocated land use rights. Allocated land use rights are distributed by the state to various users, usually for little consideration and for an indefinite term. *Id.* art. 22. Allocated land use rights are not transferable unless converted to granted land use rights and cannot be leased. *Id.* art. 39. It is current national policy to attempt to encourage holders of allocated land use rights used for commercial and industrial purposes to "convert" these rights to granted rights by paying consideration and by accepting the term limitations that are part of the granted rights. *Guoyou Qiye Gaige Zhong Huabo Tudi Shiyongquan Guanli Zanzing Guiding* [Interim Provisions on the Administration of Allocated Land Use Rights in the State-owned Enterprise Reform] (issued Feb. 17, 1998) [hereinafter Provisions on Allocated Land Use Rights], reprinted in *ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO* [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Mar. 30, 1998, at 276-80.

to generate revenue and to encourage private investments.³ The process of "privatization," although breakneck by some measures, has not yet led to a fully developed exchange economy in which market resale prices can be established with any great certainty. The value of any given parcel is very dependent upon how many new land use rights the local government will grant in an area in the near future and for what purposes such land use rights are granted. This reality, coupled with the natural socialist hostility to speculation in land, is likely to make real estate investment and, consequently, real estate lending, a less comfortable venture in China than in more developed Western nations.

In China, unlike in America, lenders are not likely to view a mortgage as their primary assurance of payment.⁴ Chinese lenders will seek virtually every other means of recovery of the debt prior to foreclosing a mortgage, and few lenders will be induced to forego such credit enhancement devices as guarantees or letters of credit by the argument that they are adequately secured by the property itself.⁵ This reluctance to rely on mortgages as security is based partly on the uncertain market value of land use rights in a society in which the supply of land is artificially controlled by state planning.⁶ Chinese lenders also fear that foreclosure rights may not be recognized, particularly when the lender is not from the area in which the foreclosure is sought. Part of this concern is based on the weakness of the

³ Since only granted land use rights are transferable, they are a necessary predicate to an active market in real estate interests.

⁴ It is a common practice in China for mortgagees to ask for additional guarantees. For instance, as a result of ongoing housing reforms, employees frequently purchase property from their employers (usually state-owned entities and government agencies). Banks lending money to employees typically ask for a guarantee from the employer as well as a mortgage on the property.

⁵ Throughout this Article, the authors make generalizations about the state of the Chinese real estate economy. These generalizations are based upon their observations and interviews in China. In the course of researching this Article and their forthcoming book on Chinese real estate law, the authors have interviewed scores of investors and lawyers engaged in the real estate economy in China. Although this method of developing an understanding of China's economy is, of course, unscientific, the authors submit that the market itself is so dynamic that it defies precise measurement, and it is so fluid that anecdotal evidence is the only practical basis for analysis.

⁶ In China, the supply of new land use rights is determined according to state plans, particularly the comprehensive land use plan and the annual land use plan. These plans set the number of land use rights to be granted during the planning period. See *Zhonghua Renmin Gongheguo Tudi Guanlifa* (Xiuzheng) [Land Administration Law of the People's Republic of China (Revised)] (adopted June 25, 1986, amended Dec. 29, 1988 and Aug. 29, 1998) [hereinafter *Land Administration Law*] art. 3, *reprinted and translated in* 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 4100/88-17-29 (1999); *Tudi Liyong Niandu Jihua Guanli Banfa* [Measures on the Management of the Annual Plan for Land Use] (issued March 2, 1999), *reprinted in* ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Apr. 5, 1999, at 255-57.

Chinese judiciary both in terms of training and independence.⁷ Another part of the concern is based on the fact that, at least until recently, Chinese judges and, for that matter, lawyers, had few resources to call upon to answer questions concerning the mortgage relationship.⁸

As the Chinese economy develops, however, values are likely to stabilize, courts are likely to become more predictable, and mortgages are likely to occupy a more significant role in the financing of China's economic development. The question remains whether the Chinese legal system, which only a decade ago had no reason to address security interests in private property at all, has matured to the point that it can resolve with fairness and certainty the myriad disputes that arise as lenders and borrowers negotiate mortgages, coexist in mortgage relationships, and terminate their relationships through payment or foreclosure.

This Article will summarize the many Chinese laws that regulate mortgage lending. It will begin with an itemization of the principle sources of law affecting mortgages and then proceed by describing the various stages of the mortgage relationship, including inception, registration, relationships during the life of the mortgage, and foreclosure and post-foreclosure. In describing each stage, the Article will synthesize the various laws to create an accurate picture of the regulation of Chinese mortgages. The Article will conclude with an assessment of the effectiveness of Chinese mortgage law as a tool for the establishment of a financial marketplace for China's new "privatized" economy.

A number of problems can be identified with China's existing mortgage law, both in the form of inconsistencies and ambiguities and in the form of actual impediments to market operation. Despite these problems, many positive things can be said about China's effort to regulate the

⁷ According to an official of the Supreme People's Court, only about 50% of China's judges have law degrees. Those with experience are accustomed to a dispute resolution system based upon mediation rather than principle. Customarily, the dispute resolution process has been part of the overall process of insuring stability, and political and judicial interchange has been common. China's new emphasis on the "rule of law" will change this process, and new graduates are emerging from Chinese law schools to take positions in the judiciary. But change, of course, will not be immediate. Discussion with Supreme People's Court official, Beijing, China (June 1999).

⁸ There was no comprehensive statute addressing mortgages prior to the Security Law of the People's Republic of China. See *infra* Part III. Zhonghua Renmin Gongheguo Danbaofa [Security Law of the People's Republic of China] (adopted June 30, 1995) [hereinafter Security Law], reprinted and translated in 3 CHINA L. REFERENCE SERVICE (Asia L. & Practice) Ref. No. 3520/95.06.30 (1997) [hereinafter 3 CHINA L. REFERENCE]. Real detail appeared only in the Measures Governing Mortgages of Urban Real Estate. Chengshi Fangdichan Diya Guanli Banfa [Measures Governing Mortgages of Urban Real Estate] (issued May 9, 1997) [hereinafter Urban Mortgage Measures], reprinted and translated as Administration of Urban Real Property Mortgage Procedures, in 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 4100/97.05.09.

mortgage market. Chinese lawmakers have recognized that predictability is vital to attracting mortgage investment, and, for the most part, they have provided a clear and workable framework within which mortgages can be created, registered, enforced, and protected in priority. Although some changes clearly are needed to improve the efficiency of the system, a basic legal structure governing mortgages now exists in China. However, problems of enforcement uncertainty and the inconsistency of market values will continue to plague the Chinese real estate economy. Such problems would hamper any economy emerging from an undeveloped state as rapidly as China's has. In China, these problems will impede the development of an active mortgage market to a greater degree than will problems in the legal structure.

II. MORTGAGE⁹ LOANS GENERALLY

The 1994 Urban Real Estate Law defines a real estate mortgage as an arrangement quite similar to a mortgage in the West.

A real estate mortgage is an arrangement whereby a party¹⁰ [the mortgagor] provides a legal real estate interest to another [the mortgagee] as security for the performance of an obligation. During the term of the mortgage, the mortgagor may continue to hold and control the property. If the mortgagor does not perform the secured

⁹ A vocabulary note may be useful here for parties dealing with their Chinese counterparts and discussing matters affecting real estate finance. Under the law prevailing in the majority of American jurisdictions, the mortgage interest is described as a lien, and in all jurisdictions lawyers might use this term to describe a mortgage when discussing real estate interests. Chinese, however, commonly use the English term "lien" to refer only to a special right held by artisans for their service fees. The lien is a possessory right arising from the artisan's possession of the property for purposes of the work being conducted. The artisan is not required to relinquish the property until such time as the artisan's claim has been paid. This security claim, coupled with possession, has a theoretical counterpart in American mortgage law, as there is some authority that a mortgage creditor in peaceful possession of the debtor's property does not have to return the property to the debtor until the debtor has satisfied the creditor's claim. But this concept has little practical application in America, and is not, in any event, the artisan's lien that the Chinese have in mind when they use the term "lien."

¹⁰ Under Chinese law, the mortgagor need not be the debtor. See *Zhonghua Renmin Gongheguo Minfa Tongze* [General Principles of the Civil Law of the People's Republic of China] (adopted Apr. 12, 1986) [hereinafter *General Principles of Civil Law*] art. 89, reprinted and translated in *ZHONGHUA RENMIN GONGHEGUO SHEWAI FAGUI HUIPIAN*, 1949-1990 [LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNING FOREIGN-RELATED MATTERS, 1949-1990] 45-68, 331-359 (1991). Article 89 provides that "the debtor or a third party may offer a specific property as a mortgage." *Id.* See also *Security Law*, *supra* note 8, art. 33.

obligation, the mortgagee may have an auction of the property and will have a priority claim to the proceeds from such an auction.¹¹

Notwithstanding the tilt toward fairness and good faith that characterizes Chinese law generally, Chinese mortgage law tends to reflect a distinct pro-creditor bias, perhaps because institutional lenders have raised these problems in lobbying for stronger collection rights. This characteristic stands in sharp contrast to Chinese landlord/tenant law, which derives from housing arrangements and consequently tends to favor tenant interests to a much greater degree than American law.¹² But, as stated, the pro-creditor bias of Chinese mortgage law does not seem to have been sufficient to induce lenders to rely heavily on mortgage security as a basis for loan underwriting decisions.¹³

New policies encouraging real estate mortgage loans for home purchases¹⁴ may have an impact on the attitudes of Chinese banks toward commercial loans. Traditionally, most home loans have been made by friends and family members. This fact is changing dramatically, as China has decided to abandon the concept of socialized housing for most of its citizens and is undergoing a massive transformation to private home acquisition.¹⁵ In connection with this, China has developed new regulations

¹¹ Urban Real Estate Law, *supra* note 2, art. 46. Article 33 of the Security Law also contains a general definition of mortgages, which includes more than just real estate mortgages. Security Law, *supra* note 8, art. 33. The definition is quite similar to that given here, but states that the mortgage creditor will have priority over the property itself or over the proceeds of the sale or auction of the property. *Id.* Note that the more restrictive language of the Urban Real Estate Law indicates that there can be no foreclosure sale of mortgaged real estate other than by auction. Urban Real Estate Law, *supra* note 2, art. 46; *see also infra* notes 303-305 and accompanying text. Note that the 1990 Regulations on Granting Land Use Rights include the bankruptcy of the obligor as a possible event of foreclosure. 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 36. It is not clear whether the omission of a reference to bankruptcy in the Urban Real Estate Law was intended.

¹² The authors have written an article on the tenant-oriented nature of Chinese law in the commercial leasing area. *See* Patrick Randolph & Lou Jianbo, *Commercial Leasing in China*, 15 UCLA PAC. BASIN L. J. 86, at 111-12, 117-21 (1996).

¹³ *See supra* notes 4-8 and accompanying text.

¹⁴ *See* Geren Zhufang Daikuan Guanli Banfa [Measures Governing Individual Housing Loans] (issued May 1998) [hereinafter Individual Housing Loans Measures], *reprinted in* FANGDICHANBAO [REAL EST. DAILY] May 26, 1998. The Individual Housing Loans Measures repealed the Geren Zhufang Danbao Daikuan Guanli Shixing Banfa [Interim Measures Governing Guarantee Against Security for Individual Housing] (issued Apr. 28, 1997), *reprinted in* ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Oct. 17, 1997, at 1412-17.

¹⁵ China has taken a system in which the state provided apartments for the employees of government or state-owned enterprises and has begun to convert it into a nearly free market. Where once workers in state work units could count on lifelong, heavily subsidized housing, apartment prices will now be set by market demand. In addition, workers will be given chances to buy their own homes. The government started work on a practical housing reform plan three years ago. Zhu Rongji, China's new premier, promised an end to the previous system at a press conference on March 19, 1998. He stated that China

that will result in far more home loans on terms more like those available to Western home buyers.¹⁶ It is possible that these loans will become the foundation for a new secondary market. In turn, we may see a mechanism for real estate financing in home mortgages that will provide a template for the commercial securitization of mortgages,¹⁷ as has happened in the West.¹⁸ Lenders may begin to look at real estate as a favored form of security as they do in some Western countries.

In addition to the new housing policies, a change in banking regulation at the beginning of 1998 also may have an impact on mortgage lending decisions in China.¹⁹ Prior to 1998, China's central bank, the

would "reform the current policy of welfare housing so that people can purchase their homes." See *Housing Reform: Q & A*, CHINA DAILY, Jun. 18, 1998, at 3. Under the new system, work units will no longer distribute public housing. In principle, newly built houses will only be sold to city dwellers. Public housing that was previously distributed will be sold or rented to residents, but rents will rise considerably. State employees will have the chance to buy their own homes with the help of subsidies, public housing reserve funds, bank loans, and their own savings. After they purchase homes, they will be required to pay off the loans over time in basically the same manner that a mortgage would be paid off. All commercial banks are allowed to provide mortgage loans to potential buyers with no limit on the amount of the loan.

¹⁶ Individual Housing Loans Measures, *supra* note 14. Although there have been reports that banks in China are prepared to offer long-term, low-interest mortgage loans, the authors' conversations with Beijing housing developers indicate that privately, the banks are insisting on guarantees from the developers and an agreement that the developer will buy at any foreclosure sale in order for the bank to offer such loans on new housing. Similarly, at a major new housing project for faculty of Beijing University and Tsinghua University, the universities will be required to guarantee the mortgage loans for faculty who wish to borrow to acquire their units.

¹⁷ There are discussions in China about the securitization of mortgaged housing loans. See, e.g., Min Xuesong, *Geran Zhufang Diya Zhengquanhua de Shikao* [*Considerations on Securitization of Personnel Housing Mortgage Loans*], 2 ZHONGGUO FANGDICHAN JINRONG [CHINA REAL EST. FINANCING] 24, 24-26 (1998). The success of this program depends upon the basic cash flow underlying it. One wonders whether Chinese workers will pay their mortgages in a timely fashion. It should be kept in mind that for several decades Chinese workers have enjoyed housing that cost them a pittance and provided them with extensive protection against eviction. This experience is likely to cause workers to believe that they will not lose their homes promptly if they miss a mortgage payment. If they do not fear the consequence of default, will there be other incentives to insure prompt payment? And who will take the risk that they will not? It is unlikely that international securities markets will do so. The securitization issue in China has floundered for two years while Chinese officials grapple with the reality that some "deep pocket," likely within China, will have to provide meaningful credit enhancement to make any securitized housing loan offerings marketable. See Wang Ying, *Insurers Shy away from Mortgages*, CHINA DAILY (Bus. Wkly. Edition), June 5, 1999, at 5. Of course, Chinese state-regulated and state-supported insurance companies may ultimately take the risk and buy the bonds. These are still Chinese entities, however, and they would take on the risk of default as a result of government pressure.

¹⁸ Although the authors acknowledge the possibility that a large securitized home mortgage marketplace will emerge, one of them is skeptical as to whether this will occur absent government guarantees of mortgage debts. If government guarantees are necessary, this author suggests that there are more efficient ways than a free-laden securitization process for the government to subsidize housing loans. See Patrick Randolph, *Is Securitization the Answer for China's Housing Needs?*, WORLD SECURITIZATION NEWS & COMMENT, Dec. 1998, at 1.

¹⁹ See Dai Xianglong, *Wei Jianli Xiandai Jinrong Tixi, Jinrong Zhidu he Lianghao de Jinrong Chixu er Nuli* [*The Objectives of a New Round of Financial Reform and Development*], ZHONGGUO JINRONG [CHINA FIN.], no. 2 (1998), at 6.

People's Bank of China ("PBOC"), developed "credit ceiling controls" for each state-owned commercial bank. These controls set forth in detail expectations related to the amount of loans which banks could make in various categories and for various terms.²⁰ The plans significantly reduced the inclination of lenders to take advantage of special lending opportunities, such as relatively high-credit real estate loans, if these opportunities were not part of the plan.

An even more important feature of the credit plans that discouraged mortgage lending was the fact that the plans set forth an expectation of a cash return on existing loan portfolios.²¹ This seemingly common-sense provision had an impact on the inclination of Chinese lenders to make mortgage loans because it inhibited their ability to acquire the security property in the foreclosure process.²² Under the Chinese credit plans, if the choice was to accept an inadequate cash bid at a foreclosure auction or bid a credit on the debt in a higher amount, the lender might have elected to take the cash bid, as this would result in some return during the relevant period. The lender might ultimately have done better financially if it had "bid in the debt" and acquired the property itself for later resale. But this process might have run beyond the applicable measuring period in the credit plan, resulting in a more restricted credit plan in the future. Therefore, because it was logical that lenders tended to devalue mortgages as sources of security for loans, the mortgage foreclosure could result in a disappointing return

²⁰ The credit planning system was established in accordance with the Zhongguo Renmin Yinhang Xindai Zijin Guanli Banfa [Interim Measures of the People's Bank of China on the Management of Credit Funds] (issued Oct. 8, 1984) [hereinafter Measures on the Management of Credit Funds], reprinted in JINRONGFA SHIWU YU GUIZE [PRACTICE AND RULES OF FINANCE LAW] 541-44 (1995). According to these measures, the People's Bank of China managed the Renminbi credit funds under an integrated credit plan and approved the credit plan of each state-owned bank. *Id.* Compliance with the credit plan had a significant impact on the government's attitude toward the bank and the banker. See Fernando Montes-Negret, *China's Credit Plan: An Overview*, 11 OXFORD REV. ECON. POL'Y 25, 31-32 (1995).

²¹ The implementation of the credit plan depends on the uninterrupted cash flow between lenders and borrowers. Montes-Negret, *supra* note 20, at 32-33.

²² The ability to acquire the property at foreclosure, and hold it until the market turns, makes it possible to recoup losses on the loan. It is also an important factor that makes mortgage loans in Western countries desirable to lenders. An important reason why mortgage lending is attractive to lenders in other countries is that the land given as security represents potential value that can provide the ultimate protection against loss. This potential value, however, cannot always be realized in the context of an emergency liquidation like a foreclosure sale. Consequently, it is common in America for lenders to "bid in the debt" or bid part of the debt, and outbid anyone else interested in purchasing at the foreclosure sale. The lenders make this decision because they believe that ultimately they will be able to dispose of the property after a holding period for an amount that is in excess of the relatively low "fire sale" prices that competing bidders might be willing to pay at the foreclosure auction. If a lender was penalized for acquiring and holding property at foreclosure as opposed to accepting low cash bids, the lender might be less inclined to see special value in real estate as security and would emphasize loans secured by more readily liquidated assets or project loans with lower returns but higher security protection.

following some investments for source. The credit plan control system was terminated in 1998, however.²³ The changes removed one more impediment to an active real estate mortgage market in China.

Except for the provisions which prohibit a commercial bank's investment in real estate,²⁴ the only current regulations that restrict commercial mortgage lending are those that relate to interest rate control.²⁵ State-owned Chinese commercial banks may adopt regulations affecting their own banking activities.²⁶ The relevant provisions in these regulations are usually included in the standard terms²⁷ which Chinese banks include in contracts with their clients²⁸ and thus control the lending practices undertaken by branches of those banks. The enactment of the 1999 Contract Law, however, may give the parties to loan agreements some chance to challenge the validity of standard terms provided by the banks. Article 39 of the Contract Law requires that the standard terms follow general principles of fairness and that the party supplying the standard terms define the rights and obligations between the parties, point out to the other party the exclusion or restriction of its liabilities, and explain the standard terms if the other party has any questions.²⁹ Article 40 provides that contract terms shall be null and void when standard terms appear in contracts arising under the circumstances stipulated in Article 52³⁰ or Article 53³¹ of the Contract Law,

²³ See Dai Xianglong, *supra* note 19.

²⁴ The Commercial Banking Law prohibits commercial banks from investing in real estate that is not for their own use and provides that a commercial bank shall dispose of the real estate on mortgage within one year of the date that it was obtained. See Zhonghua Renmin Gongheguo Shangye Yinhangfa [Commercial Banking Law of the People's Republic of China] (adopted May 10, 1995) [hereinafter Commercial Banking Law] arts. 42, 43, translated in 3 CHINA L. REFERENCE, *supra* note 8, Ref. No. 3610/95.05.10.

²⁵ See *infra* note 160.

²⁶ This is sometimes encouraged by the People's Bank of China. Commercial banks are authorized to adopt implementing rules under the Individual Housing Loans Measures. Individual Housing Loans Measures, *supra* note 14, art. 37.

²⁷ Standard terms are defined as clauses that are prepared in advance for general and repeated use by one party and that are not negotiated. Zhonghua Renmin Gongheguo Hetongfa [The Contract Law of the People's Republic of China] (adopted Mar. 15, 1999) [hereinafter Contract Law] art. 39, reprinted and translated in 2 CHINA L. REFERENCE SERVICE (Asia L. & Practice), Ref. No. 2200/99.03.15 (1999) [hereinafter 2 CHINA L. REFERENCE].

²⁸ Interview with Mr. Huang Yangxing, General Manager of the Department of Financial Institutions, Bank of China, Beijing, China (June 1999).

²⁹ Contract Law, *supra* note 27, art. 39.

³⁰ Article 52 states:

A contract shall be null and void under any of the following circumstances: (1) a contract is concluded through the use of fraud or coercion by one party to damage the interests of the State; (2) malicious collusion is conducted to damage the interests of the State, a collective, or a third party; (3) an illegitimate purpose is concealed under the guise of legitimate acts; (4)

or when the party that supplies the standard terms exempts itself from its liabilities,³² weights the liabilities of the other party, and excludes the rights of the other party.³³

With regard to the interpretation of standard terms, Article 41 provides that a standard term shall be interpreted according to the general understanding of that term's meaning.³⁴ When there are two or more interpretations possible, the interpretation unfavorable to the party supplying the standard term is preferred.³⁵ More importantly, Article 41 provides that where the standard terms are inconsistent with non-standard terms, the latter shall be adopted.³⁶ All of these provisions establish, at least to some extent, protections for borrowers against a bank's abuse of its bargaining power.

III. UNDERLYING STATUTES

China recently has developed a series of laws and regulations that will have a direct impact on mortgage lending. These laws and regulations, by their express or implicit terms, apply to real estate mortgage loans made by foreign lenders as well as by Chinese lenders. The General Principles of Civil Law state clearly that Chinese law will control rights as to real estate interests in China,³⁷ so choice of law clauses in foreign loan contracts likely will not alter a Chinese law result insofar as the real estate rules are concerned.

[the contract is] damaging to the public interest; or (5) [the contract] violates the compulsory provisions of the laws and administrative regulations.

Id. art. 52.

³¹ Article 53 states: "The following immunity clauses in a contract shall be null and void: (1) those that cause personal injury to the other party; and (2) those that cause property damage to the other party as a result of deliberate intent or gross fault." *Id.* art. 53.

³² There is obviously an inconsistency between Article 39 and Article 40 on the issue of immunity from liability or removing such immunity. Article 39 states that such provisions must be explained, but Article 40 prohibits them altogether. *Id.* arts. 39-40. This conflict has not yet been addressed by Chinese lawmakers.

³³ *Id.* art. 40.

³⁴ *Id.* art. 41.

³⁵ *Id.*

³⁶ *Id.*

³⁷ See General Principles of Civil Law, *supra* note 10, arts. 144, 149; Zuigao Renmin Fayuan Guanyu Guanche Zhixing "Zhonghua Renmin Gongheguo Mingfa Tongze" Ruogan Wenti de Yijian [Opinions of the Supreme People's Court on Issues Concerning the Implementation of the General Principles of Civil Law] (issued Jan. 26, 1988) [hereinafter Opinions on the General Principles of Civil Law] art. 186, available in ZHONGHUA RENMIN GONGHEGUO FALU QUANSHU 1949-1989 [COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1949-1989] 350-363 (Wang Huaian et al. eds., 1989).

A. *The 1999 Contract Law*

China's new Contract Law, which became effective October 1, 1999, contains a chapter on lending,³⁸ and many of its other provisions also apply to contracts involving loans and mortgages. The law requires loan contracts to be in writing, but provides that "natural persons" can contract for a loan that is not in writing.³⁹ Contracts for loans between natural persons, however, are not valid until the money actually is loaned.⁴⁰

In keeping with the common bias toward lenders in Chinese law, the Contract Law contains provisions for which lenders in Western countries would have to bargain. The Contract Law provides that lenders can supervise the expenditure of loan proceeds⁴¹ and that borrowers have a duty to provide regular financial reports to lenders.⁴² Although the Contract Law does have a number of provisions dealing with loans generally, the only specific provision on mortgage loans it contains is a provision which states that the Security Law shall apply to mortgage loans.⁴³

B. *The 1995 Commercial Banking Law and the General Provisions on Lending*

The 1995 Commercial Banking Law contains provisions on commercial lending in China.⁴⁴ These provisions apply to mortgage lending as well as to other forms of commercial lending. The General Provisions on Lending, issued by the People's Bank of China, deal with relationships between banks as lenders and their borrowers.⁴⁵ In addition, there are special regulations on bank loans secured by real estate mortgages and on housing loans generally.⁴⁶

³⁸ Contract Law, *supra* note 27, arts. 196-211.

³⁹ *Id.* art. 197. Note, however, that Article 36 provides for a "part performance" concept that likely would render the terms of a verbal agreement enforceable once the lender has advanced the loan. *Id.* art. 36.

⁴⁰ *Id.* art. 210.

⁴¹ *Id.* art. 202. Failure to comply with the usage terms justifies acceleration or rescission of the loan agreement. *Id.* art. 203.

⁴² *Id.*

⁴³ Article 198 of the Contract Law provides, "In concluding a loan contract, the lender may require the borrower to provide a security. The security shall abide by the provisions of the Security Law of the People's Republic of China." *Id.* art. 198.

⁴⁴ Commercial Banking Law, *supra* note 24, arts. 34-42.

⁴⁵ Zhongguo Renmin Yinhang Daikuan Tongze [People's Bank of China, Lending General Provisions] (adopted June 28, 1996) [hereinafter General Provisions on Lending], *reprinted and translated in* 3 CHINA L. REFERENCE, *supra* note 8, Ref. No. 3610/96.08.01 (1997).

⁴⁶ See, e.g., Individual Housing Loans Measures, *supra* note 14.

C. *The 1995 Security Law*

The 1995 Security Law provided some clarity to what earlier had been a somewhat underdeveloped law of mortgages. Although named the "Security Law," the statute actually deals with more than just security matters as that term generally is used in America. The Security Law contains provisions covering all kinds of assurances given to support a contract promise, including guarantees, mortgages, pledges, liens, and earnest money posting. The Security Law includes a special chapter on mortgages.⁴⁷ A number of articles in that chapter specifically deal with real estate mortgages.⁴⁸

D. *The 1996 Auction Law*

The Auction Act, effective in 1997, set up a uniform process for auctions of real and personal property in the foreclosure of mortgages, in satisfaction of judgments, or for general commercial purposes.⁴⁹

E. *Laws and Regulations on Land and Urban Real Estate*

The Ministry of Construction and the former State Bureau of Land Administration⁵⁰ have issued regulations which have had some impact on mortgage loans. These include the Interim Measures Governing Urban Real Property Development (issued by the Ministry of Construction in 1995),⁵¹ the Measures Governing Urban Real Estate Transfers (issued by the

⁴⁷ Security Law, *supra* note 8, ch. 3.

⁴⁸ *Id.* arts. 34, 36-37, 42, 55-56.

⁴⁹ Zhonghua Renmin Gongheguo Paimaifa [Auction Law of the People's Republic of China] (adopted July 5, 1996) [hereinafter Auction Law], translated in THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1996 201-213 (1997).

⁵⁰ In accordance with the Decision on Government Structure Reform adopted at the Ninth National People's Congress, the State Bureau of Land Administration is now part of the Ministry of Land and Resources. See Dijiujie Quanguo Renmin Daibiao Dahui Diyi Huiyi Guanyu Guowuyuan Jigou Gaige Fang'an de Jueding [Decision of the First Session of the Ninth National People's Congress on the Plan for Institutional Reform of the State Council], (adopted Mar. 10, 1998), reprinted in ZHONGHUA RENMIN GONGHEGUO QUANGUO RENMIN DAIBIAO DAHUI CHANGWU WEIYUANHUI GONGBAO [GAZETTE OF THE STANDING COMMITTEE OF THE NATIONAL PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA], Apr. 10, 1999, at 51-57.

⁵¹ Chengshi Fangdichan Kaifa Guanli Zanzing Banfa [Interim Measures Governing Urban Real Property Development] (issued Jan. 13, 1995), reprinted and translated as PRC, Administration of Urban Real Property Development Tentative Procedures, in 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 4110/95.01.23 (1997).

Ministry of Construction in 1995),⁵² and the Measures Governing Mortgages of Urban Real Estate (issued by the Ministry of Construction in 1997).⁵³ Rules on real estate registration⁵⁴ also have relevance to mortgage lending.

Local government may also regulate real estate. Such regulations control real estate mortgages in the affected areas. The Shanghai municipal government, for example, has promulgated a large number of real estate regulations.⁵⁵

In addition, there are recent measures dealing with special concerns in land use law, which include concerns related to state-owned land and foreign investment in land. These are the Land Administration Law,⁵⁶ the 1990 Tentative Regulations on the Granting and Transfer of Land Use Rights on Urban State-owned Land,⁵⁷ the Interim Measures for the Administration of Foreign-Invested Development and Management of Tracts of Land,⁵⁸ and the 1994 Urban Real Estate Law.⁵⁹

⁵² Chengshi Fangdichan Zhuanrang Banfa [Measures Governing Urban Real Estate Transfers] (issued Apr. 28, 1995) [hereinafter Measures Governing Urban Real Estate Transfers], *reprinted in* ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Jan. 2, 1996, at 1287-91.

⁵³ Urban Mortgage Measures, *supra* note 8. These regulations are specific as to mortgages on urban real estate and will control a number of issues discussed here. The regulations include a number of very detailed provisions dealing with various specific aspects of the mortgage relationship, including the duty of the mortgagor not to transfer or lease the mortgaged property without the mortgagee's consent and the duty of the mortgagor to address the problem of damages to the mortgaged property. *See infra* Part IX.B.2.

These regulations do not apply to land use right mortgages on empty land. Empty land is land without finished buildings or state-owned land with buildings under construction with land use rights that may be mortgaged. Urban Mortgage Measures, *supra* note 8, art. 2.

⁵⁴ The registration rules are discussed in detail in Part VIII. Registration is governed by the following rules and regulations: Chengshi Fangwu Quanshu Dengji Guanli Banfa [Measures Governing the Registration of Titles in Urban Buildings] (issued Oct. 24, 1997), *reprinted in* ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Dec. 12, 1997, at 1568-74; Tudi Dengji Guize [Land Registration Rules] (issued Dec. 31, 1995), *reprinted and translated in* 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 4100/96.02.01 (1997); Guanyu Tudi Shiyongquan Diya Dengji Youguan Wenti de Tongzhi [Circular on Issues Concerning the Registration of Mortgages on Land Use Rights] (issued Jan. 3, 1997) [hereinafter Mortgage Registration Circular], *reprinted in* ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Apr. 21, 1997, at 575-78.

⁵⁵ Shanghai has taken a leading position in China's land and housing reform. Some of its regulations precede the national regulations. *See, e.g.,* Shanghai Fangdichan Diya Banfa [Shanghai Municipality, Real Property Mortgage Measures] (issued Aug. 22, 1994), *reprinted in* Zhang Chongguang & Cheng Huiying, BUDONGCHAN KAIFA YU JIAOYI—FANGDICHANFA DE LILUN YU SHIWU [REAL ESTATE DEVELOPMENTS AND TRANSACTIONS—THEORIES AND PRACTICES OF REAL ESTATE LAW] 211 (1997). The Shanghai regulations were issued in 1994, almost three years before the Urban Mortgage Measures. *Id.*

⁵⁶ Land Administration Law, *supra* note 6.

⁵⁷ 1990 Regulations on Granting Land Use Rights, *supra* note 2.

⁵⁸ Waishang Touzi Kaifa Jingying Chengpian Tudi Zanxing Guanli Banfa [Interim Measures for the Administration of Foreign-invested Development and Management of Tracts of Land] (issued May 19, 1990), *reprinted in* ZHONGHUA RENMIN GONGHEGUO FALU QUANSHU, 1990-1992 [COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, 1990-1992] 1767-69 (Wang Huaian et al. eds., 1993). The

IV. THE DISTINCTION BETWEEN "RIGHTS *IN REM*" AND "CREDIT RIGHTS"

Chinese civil law distinguishes between two types of interests that relate to real property:⁶⁰ "credit rights," including obligations owed to others under contracts,⁶¹ and "rights *in rem*," which are equivalent to the right of ownership as conceived in the civil law.⁶²

An *in rem* right is entitled to protection by the state against interference from all the world.⁶³ If the state interferes with an *in rem* right, it must compensate the owner of the right.⁶⁴ An *in rem* right generally

effect of these measures is limited within the special economic zones, coastal open cities, and coastal economic open areas.

⁵⁹ Urban Real Estate Law, *supra* note 2.

⁶⁰ ZHONGGUO MINFAXUE YANJIU SHUPING [COMMENTS ON STUDIES OF CHINESE CIVIL LAW] 75 (Liu Xingwen ed., 1996).

⁶¹ General Principles of Civil Law, *supra* note 10, arts. 84-93. Contract rights are identified as credit rights in Articles 84 and 85. *Id.* arts. 84-85. Another type of credit right is a claim for unjust enrichment. *Id.* art. 92. Tort claims are not listed as credit rights in the General Principles of Civil Law, but scholars tend to view them as credit rights as a matter of theory. See ZHONGGUO MINFAXUE YANJIU SHUPING, *supra* note 60, at 456-58.

There is another form of credit right recognized for "object management." These credit rights accrue when benefits in the form of avoidance of loss or injury are conferred upon a person by another person who has no legal obligation to provide such benefits, and when the circumstances are such that it would be unfair for the party to receive the benefit without compensating the benefactor for the costs incurred. General Principles of Civil Law, *supra* note 10, art. 93. As an example of the latter right, consider the following example: A farmer is away from his farm and a storm endangers his wheat crop. The farmer's neighbor hires laborers to harvest the wheat crop, thereby rescuing it from destruction. The farmer owes his neighbor the cost of the laborers' wages, but need not compensate the neighbor for anything more than the neighbor's costs.

⁶² "Property Ownership and Other Property Rights Related to Ownership" is a heading used in Section 1, Chapter 5 of the General Principles of Civil Law. General Principles of Civil Law, *supra* note 10, ch. 5. Besides providing for issues of ownership, including state ownership, collective ownership, and individual ownership, the General Principles of Civil Law provide for the right of succession, land use rights, natural resource use rights on state-owned land, mineral rights on state-owned land, management rights of state-owned enterprises, and neighborhood rights. *Id.* arts. 74-76, 80-83. Although the General Principles of Civil Law do not use the term "rights *in rem*," it is accepted among Chinese scholars that the rights provided for in the General Principles of Civil Law under the title "Property Ownership and Other Property Rights Related to Property Ownership" are "*in rem*" rights. See QIAN MINXING, WUQUANFA YUANLI [PRINCIPLES OF RIGHTS *IN REM*] 126 (1994). See also WANG LIMING, WUQUAN FALUN [STUDIES ON RIGHTS *IN REM*] 81-82 (1998).

⁶³ MINFA XUE [TEXTBOOK OF CIVIL LAW] 253-54 (Li Youyi ed., 1988). This characteristic can be seen quite clearly in the General Principles of Civil Law provisions on ownership. Article 73 provides that state-owned property is sacred and inviolable, and that "no organization or individual shall be allowed to seize, encroach upon, privately divide, retain or destroy it." General Principles of Civil Law, *supra* note 10, art. 73. Article 74 provides that "collectively owned property shall be protected by law, and no organization or individual may seize, encroach upon, privately divide, destroy or illegally seal up, distrain, freeze or confiscate it." *Id.* art. 74. Article 75 provides that "a citizen's lawful property shall be protected by law, and no organization or individual may appropriate, encroach upon, destroy or illegally seal up, distrain, freeze or confiscate it." *Id.* art. 75. The term "no organization or individual" clearly indicates that ownership is protected against interference from the whole world.

⁶⁴ Urban Real Estate Law, *supra* note 2, art. 19. Article 19 provides that if the state revokes a granted land use right before the expiration of the right, it is obliged to compensate the land user. The state

inheres in something tangible, like a parcel of land or a building, but such a right can exist in movable as well as immovable property.⁶⁵ The holder of an *in rem* right has a right to protect the thing in which the right inheres⁶⁶ and has a claim for damages if that thing is damaged.⁶⁷ A right *in rem* may not be taken or transferred from an owner without the owner's consent. If another individual deprives one of something in which one has an *in rem* right, the state will restore possession.⁶⁸ Note that an *in rem* right in a land use right arises only upon registration of the land use right.⁶⁹ An *in rem* right is mortgageable or pledgeable,⁷⁰ and the mortgage interest⁷¹ or pledge interests⁷² themselves are rights *in rem*.

Scholarly opinion is that an *in rem* right can exist in a tangible embodiment of an intangible right such as a bond or a share of stock.⁷³ For instance, a share interest in a joint stock company represented by a formal, publicly traded share probably can form the basis for an *in rem* right. A lease right, however, is a mere contract right and is not *in rem*.⁷⁴ The same is true of a Chinese "judgment lien," which creates the right to have a debtor's property applied in satisfaction of a debt. Similarly, the contract right of a purchaser under a land sale contract is not an *in rem* right. China does not indulge in the "equitable conversion" concept that is sometimes applied in the common law.

can only revoke the right for reasons related to the social public interest. Compensation is based upon the time of usage and the user's investment. *Id.*

⁶⁵ MINFA XUE, *supra* note 63, at 253-54.

⁶⁶ A holder of *in rem* rights can protect the things in which the right inheres by making a claim for "cessation of infringements," "removal of obstacles," "elimination of dangers," "return of property" or "restoration of original condition." General Principles of Civil Law, *supra* note 10, art. 134.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ See, e.g., Land Administration Law, *supra* note 6, arts. 11-13; Urban Real Estate Law, *supra* note 2, arts. 59-61; Security Law, *supra* note 8, arts. 41-42.

⁷⁰ The Security Law distinguishes a pledge from a mortgage. Movable property, negotiable instruments, and property rights listed in the Security Law may be pledged. Security Law, *supra* note 8, arts. 63, 75. A pledgee takes possession of the property or negotiable instruments. *Id.* arts. 63, 76. For a pledge of other property rights, such as those in stocks or intellectual property, the pledge is perfected by registration. *Id.* arts. 78-79. Only property listed in Article 34 of the Security Law, which primarily includes real estate (including land use rights) and other fixed assets, can be mortgaged. The possession of the property cannot be transferred under a mortgage. *Id.* art. 33.

⁷¹ ZHONGGUO MINFAXUE YANJIU SHUPING, *supra* note 60, at 415.

⁷² *Id.* at 426-28.

⁷³ Further, Article 75 of the Security Law provides that money orders, checks, cashier's checks, securities, deposit receipts, warehouse receipts, bills of lading, shares, and share certificates that are legally transferable can be used in a hypothecation-pledge. Security Law, *supra* note 8, art. 75.

⁷⁴ See, e.g., WANG LIMING ET AL., MINFA XINLUN, I [ADVANCED STUDIES IN CIVIL LAW, VOL. I] 15 (1988).

A "credit right" is a right against an individual party.⁷⁵ It represents a relationship between specific parties and does not enjoy protection against the world.⁷⁶ A simple contract right, for instance, is a credit right. If the actions of a third party prevent the party that owes a credit right from performing its obligation, the holder of the right has no action against the third party. It only has a claim against the obligor.⁷⁷

V. WHO CAN MAKE A MORTGAGE LOAN?

Only banks and other properly licensed financial institutions (including branches of foreign banks) can be in the business of lending money.⁷⁸ Government entities are not permitted to make private loans themselves, but they may provide funds to a bank that in turn holds the loan in a revolving fund that is a source of financing for designated projects.⁷⁹ Private individuals cannot engage in the business of lending money, but they occasionally can

⁷⁵ *Id.* at 4.

⁷⁶ In China, a debt is defined as a "special relationship of rights and obligations established between the parties concerned, either according to the agreed terms of a contract or legal provisions." General Principles of Civil Law, *supra* note 10, art. 84. In a debt relationship, the creditor has the right to demand that the debtor fulfill his obligations as specified by the contract or according to legal provisions. *Id.* Thus, a debt relationship exists only among the parties concerned.

⁷⁷ For a more detailed discussion of rights *in rem* and credit rights, see QIAN MINXING, *supra* note 62, at 9-38.

⁷⁸ There is some controversy over this point. Despite the numerous People's Bank of China circulars prohibiting mutual lending between enterprises, there are no clear prohibitions in the Commercial Banking Law, the General Provisions on Lending, or the Regulations on Loan Agreement. For the Regulations on Loan Agreement, see Jiakuan Hetong Tiaoli [Regulations on Loan Agreement] (issued Feb. 28, 1985) [hereinafter Regulations on Loan Agreement], reprinted in ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Mar. 20, 1985, at 133-36. According to the Mortgage Registration Circular, a lender that is not a financial institution will have to demonstrate to the registration officials prior to registration of the mortgage that it has the authority to lend. The Mortgage Registration Circular indicates, however, that a non-financial institution can be a lender also. Mortgage Registration Circular, *supra* note 54, art. 5.

The attitude of the Supreme People's Court is also very ambiguous. The 1990 Answers on Several Questions Related to Cases on Disputes over Contracts of Economic Association provide that "contracts of economic association" (which are essentially loan agreements) shall be held void if the "lender" is a non-financial legal person because such contracts are in breach of the relevant financial regulations, and that the parties to such contracts shall be fined. Zuigao Renmin Fayuan Guanyu Shenli Lianying Hetong Jiufen Anjian Ruogan Wenti de Jieda [Answers on Issues Related to Cases on Disputes over Contracts of Economic Association] (issued Nov. 12, 1990) art. 4(2), reprinted in ZHONGHUA RENMIN GONGHEGUO ZUIGAO RENMIN FAYUAN GONGBAO [GAZETTE OF THE SUPREME PEOPLE'S COURT OF THE PEOPLE'S REPUBLIC OF CHINA], Sept. 20, 1990, at 23-25. There are cases, however, in which courts enforce loan agreements between non-financial enterprises in accordance with Article 84 and Article 90 of the General Principles of Civil Law. See ZUIGAO RENMIN FAYUAN SHENLI DE ERSHEN ZAISHEN JINGJI JIUFEN ANLI XUANBIAN [SELECTIONS OF ECONOMIC DISPUTE CASES HEARD BY THE SUPREME PEOPLE'S COURT] 201-204 (1997).

⁷⁹ General Provisions on Lending, *supra* note 45, art. 7.

lend money to other individuals or entities.⁸⁰ Banking laws do not require that lenders obtain mortgages on real property, but Chinese banks frequently demand security interests for their loans.⁸¹

Most mortgage loans are made on major projects. Small business loans frequently are made through informal arrangements with the borrower's business or with personal friends or family.⁸² Some local government entities now are seeking ways to encourage small businesses by providing advice or subsidies.⁸³

Presently in China, sellers of property do not appear to be in the practice of taking purchase money in mortgages. There is nothing in the definition of a mortgage, however, that would preclude such devices.

⁸⁰ Zuigao Renmin Fayuan Guanyu Renmin Fayuan Shenli Jiedai Anjian De Ruogan Yijian [Opinions of the Supreme People's Court on Cases Concerning Loan Relations] (issued Aug. 13, 1997) arts. 1, 2, available in ZHONGHUA RENMIN GONGHEGUO ZUIGAO RENMIN FAYUAN GONGBAO [GAZETTE OF THE SUPREME PEOPLE'S COURT OF THE PEOPLE'S REPUBLIC OF CHINA], Oct. 20, 1991, at 34-36. The Opinions provide that loan relations between individuals, and between individuals and entities, shall be protected.

⁸¹ Commercial Banking Law, *supra* note 24, art. 3. In accordance with this provision, borrowers in the commercial banking loan context must provide security interests unless their lenders are assured that they have good credit and the ability to repay the loan on time. The 1985 Regulations on Loan Agreement, and the General Provisions on Lending, have similar requirements. Regulations on Loan Agreement, *supra* note 78, art. 7; General Provisions on Lending, *supra* note 45, art. 10.

⁸² These arrangements are traditional among Chinese businesspersons and usually do not involve much of a security arrangement. As was explained to one of the authors after he spoke to an apparently disinterested group of Shanghai small businessmen about the need for predictability in mortgage law in order to induce mortgagees to take risks, "These men don't think of lending money to a business friend as a risk. If I lend you money, you would not embarrass me by failing to pay it back. If you do not pay it back, I would not embarrass you by asking for it."

⁸³ See, e.g., *China to Guarantee Loans for Small Business*, available in Chinaonline (visited Nov. 10, 1999) <http://www.chinaonline.com/industry/financial/NewsArchive/Secure/1999/february/fn_c9020309.asp>. Efforts have been made to improve the uncomfortable situation created by the government's emphasis on loans to huge state-owned enterprises when in fact small companies have been driving economic growth. The central government is planning to establish a system to guarantee the credit of small and medium-sized companies seeking bank loans. The system has been used on a trial basis in Shandong and Anhui Provinces and, based on its success there, will be expanded to the rest of the country. The country's Ministry of Finance is studying different methods for putting the guarantee system into place. These include earmarking part of the central government fiscal revenues for a loan guarantee fund and exempting loan guarantor companies from paying income taxes. *Id.*

The first loan guarantee center in China for small and medium-sized enterprises started operation in the city of Zhenjiang, Jiangsu Province, in February, 1999. See *China and United Nations Open Loan Center for Small and Medium-sized Firms*, available in Chinaonline (visited Nov. 10, 1999) <http://www.chinaonline.com/industry/financial/NewsArchive/Secure/1999/february/fn_b9022202.asp>.

VI. WHAT CAN BE MORTGAGED?

A. *Land Use Rights*

Granted land use rights⁸⁴ can be the subject of a mortgage.⁸⁵ The mortgagee also can obtain a separate mortgage on the buildings on such land,⁸⁶ as Chinese law views the buildings as a separate legal interest.⁸⁷

With some exceptions, allocated land use rights also can be the subject of a mortgage,⁸⁸ but this is likely only when the land has been improved with a building.⁸⁹ There is an anomaly here, however, because allocated land use rights are non-transferable, and foreclosure of the mortgage necessarily involves transfer of the property to the foreclosure sale purchaser. The problem is resolved by the requirement that a mortgagee pay a fee for conversion of the allocated land use right to a granted land use right at the time of foreclosure.⁹⁰ The fee is based on the value of the right at the time of the mortgage, and new regulations require an appraisal, confirmed

⁸⁴ See *supra* note 2 and accompanying text.

⁸⁵ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 32.

⁸⁶ The Security Law requires that when there is a mortgage on a land use right on improved land, the mortgagee must also obtain a mortgage on the buildings. Security Law, *supra* note 8, art. 36. See also 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 39.

⁸⁷ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 33. Article 60 of the Urban Real Estate Law confirms the existence of the two separate systems for land use rights registration and building ownership registration and indicates that mortgages on each could and should exist simultaneously. Urban Real Estate Law, *supra* note 2, art. 60. Article 62 of the Urban Real Estate Law authorizes the provincial governments to unify the registration and certificate issuance systems within their jurisdiction. *Id.* art. 62. In some areas, such as in Shanghai and Shenzhen, one government agency issues a uniform certificate for both interests.

⁸⁸ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 45. Note the many restrictions on mortgages on allocated land use rights set forth later in this Article.

⁸⁹ The Urban Real Estate Law provides that land use rights and the buildings on them can be mortgaged together. Urban Real Estate Law, *supra* note 2, art. 47. The same provision discusses mortgages on unimproved land use rights, and in that context mentions only granted land use rights. *Id.* On the basis of this provision, the authors infer that allocated land use rights on unimproved land are not mortgageable. Note that it would be unusual for even a granted land use right to be provided without requiring that the property be improved through the construction of buildings, so the technical right to impose a land use right on unimproved property is not particularly significant.

⁹⁰ *Id.* art. 50. The method of conversion is similar to that used outside of the foreclosure context by collectives to convert land use rights that they hold into transferable land use rights. The non-transferable interest is relinquished to the state and then re-transferred to the collective as a granted land use right. A fee is paid for this granted land use right. In the case of mortgage foreclosure, the fee is paid by the mortgagee. Note the extensive involvement of the state government in the process of the mortgagee collecting on the mortgage. Although the various steps in this process generally are routine, mortgagees should be wary of committing resources where there are so many additional and potentially discretionary steps to be taken in the process of realizing their security.

by the Bureau of Land Administration, before a mortgage can be registered.⁹¹

Another problem with lending on the security of allocated land use rights is that if the mortgage loan is made to a state-owned industrial enterprise located in certain areas and that entity were to go bankrupt, the first proceeds from the sale of its property, including its mortgaged property, would go to satisfy the social welfare obligations of that enterprise.⁹² Then, money would be paid to the state to compensate it for the land use right conversion.⁹³ Only after these payments have been made would money be paid to the mortgagee.⁹⁴

Land use rights held by foreign enterprises and foreign joint ventures may be mortgaged, but the law requires the consent of the board of directors of the joint venture for such a mortgage unless the organic documents specifically provide otherwise.⁹⁵ With regard to joint stock companies or limited liability companies set up under the Company Law, unless the organic documents specifically provide otherwise,⁹⁶ there must be an approval of mortgages either through the consent of the board of directors or a vote of the shareholders.⁹⁷ If an entity has a limit on its business life, then the term of any mortgages granted on its real estate cannot exceed the term of the enterprise itself.⁹⁸

Land use rights held by a collective-owned enterprise can be mortgaged, but not without the consent of the workers' congress⁹⁹ for that enterprise and the governmental agency or other entity claiming supervisory responsibility over such an enterprise.¹⁰⁰

⁹¹ Mortgage Registration Circular, *supra* note 54, art. 2.

⁹² Provisions on Allocated Land Use Rights, *supra* note 2, art. 6.

⁹³ See *supra* notes 89-91 and accompanying text.

⁹⁴ *Id.*

⁹⁵ Urban Mortgage Measures, *supra* note 8, art. 15.

⁹⁶ Zhonghua Renmin Gongheguo Gongsifa [Company Law of the People's Republic of China] (adopted Dec. 29, 1993) [hereinafter Company Law], reprinted and translated in 2 CHINA L. REFERENCE, *supra* note 27, Ref. No. 2330/93.12.29 (1997). The Company Law provides a legal framework within which limited liability companies (including solely state-owned companies) or joint stock limited companies can be established.

⁹⁷ Urban Mortgage Measures, *supra* note 8, art. 16.

⁹⁸ *Id.* art. 17.

⁹⁹ A workers' congress is the decisionmaking body of a collective-owned enterprise. It consists of either all the workers of that enterprise or worker representatives elected by the workers. See Zhonghua Renmin Gongheguo Chengzhen Jiti Suoyouzhi Qiye Tiaoli [Regulations on Urban Collective Enterprises] (issued Sept. 9, 1991) arts. 28-30, reprinted in ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Nov. 27, 1991, at 1148-59.

¹⁰⁰ Urban Mortgage Measures, *supra* note 8, art. 14.

B. *Multiple Parcels*

If there is a mortgage on more than one parcel, all parcels will be deemed to be one piece of property for security purposes unless the mortgage agreement provides otherwise.¹⁰¹

C. *Commonly Owned Property*

Under Article 78 of the General Principles of Civil Law, there are two basic types of co-ownership. The first type is referred to as "co-ownership by shares."¹⁰² Each owner has a pro rata share of the benefits and of the responsibilities of ownership.¹⁰³ Each owner, however, may be jointly and severally liable as to third party claims.¹⁰⁴ Under this form of ownership, the co-owner by shares may sell its interest independently or withdraw it from the co-ownership. Other members of the co-ownership may have a pre-emptive purchase right if, in the words of the General Principles of Civil Law, "all other things are equal."¹⁰⁵

There is some uncertainty regarding the mortgage of commonly owned property.¹⁰⁶ A provision in the 1997 Urban Mortgage Measures indicates that a co-owner of property must get the consent of the other co-owners for any mortgage.¹⁰⁷ This provision does not make clear whether it addresses co-ownership by shares or common ownership, and it also does not make clear whether it addresses a mortgage on the entire property or only on the co-ownership share. It appears that none of these issues has been fully addressed in the scholarly commentary or in the discussions of the civil law, so it is difficult to reach any final conclusions as to the purpose and meaning of this provision of the Urban Mortgage Measures.

¹⁰¹ *Id.* art. 10.

¹⁰² General Principles of Civil Law, *supra* note 10, art. 78.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ Co-ownership is a recognized part of Chinese law. Partnership, marriage, or other special relationships give rise to co-ownership concepts. XIN ZHONGGUO MINFAXUE YANJIU ZHONGSHU [SUMMARY OF CIVIL LAW STUDIES IN PRC] 311-12, 314 (1990). Modern private ownership of apartment units in multi-tenant buildings includes, as a matter of law, co-ownership of the building structure and the land use right for the land supporting the building. *See generally* ZHONGGUO MINFAXUE YANJIU SHUPING, *supra* note 60, at 376-80. Here there are multiple buildings in one housing development. All of the owners in the development are co-owners of the land use right and the general improvements, but only the co-owners of the units in an individual building are regarded as having ownership rights in that building.

¹⁰⁷ Urban Mortgage Measures, *supra* note 8, art. 19.

The second form of ownership is termed "common ownership."¹⁰⁸ Under this form, the owners collectively have all of the rights and are subject to all of the burdens of ownership.¹⁰⁹ They have no individually transferable rights, and consequently there is no pre-emptive right upon sale, since there can be no sale of an individual's interest.¹¹⁰ The marriage relationship is said to involve this type of co-ownership. There is no other specific marital estate.

When property is owned in co-ownership by shares, it appears that the owner of a share should be able to mortgage that share, as the General Principles of Civil Law provide that the co-owner by shares can transfer the interest.¹¹¹ As noted, the General Principles of Civil Law also provide that the other co-owners by shares have a pre-emptive right of purchase, but this pre-emptive right applies only at the time of foreclosure, not at the time of mortgage.¹¹² Further, the pre-emptive right applies only "when other things are equal."¹¹³ In a mortgage foreclosure, one would assume that the pre-emptive right would be satisfied, if it existed at all, simply by permitting the co-owners by shares to bid at the foreclosure auction. The pre-emptive right provision might restrict the ability of the co-owner by shares to arrange for a private settlement of the mortgage debt by transfer of the interest to the lender. There does not appear to be a right for an owner of a common ownership interest to mortgage its share, as the concept does not recognize a separate share that can be transferred or mortgaged.

D. Leasehold Estates

An important weakness in current Chinese mortgage law is the fact that leasehold estates, because they are credit rights and not rights *in rem*, cannot be the subject of a mortgage.¹¹⁴ American real estate transactions,

¹⁰⁸ General Principles of Civil Law, *supra* note 10, art. 78.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* The co-owners by shares can only execute the pre-emptive right of purchase when other co-owners sell their shares. Granting a mortgage on the shares does not necessarily lead to the sale of shares.

¹¹³ *Id.*

¹¹⁴ The Security Law lists the property interests that can and cannot be mortgaged. Security Law, *supra* note 8, arts. 34, 37. Neither of the two lists includes leasehold estates. The authors have drawn their conclusion from their interviews with legal professionals in China. It is commonly accepted among Chinese civil law scholars that an *in rem* right shall exist in a thing, and not in legal interest alone. See WANG LIMING, *supra* note 62, 33-42. It is therefore logical to conclude that a mortgage, as an *in rem* right, cannot be established on a leasehold estate because a leasehold estate, as a creditor's right, is only a claim against the owner of the property.

particularly in the area of shopping center financing, depend heavily upon the device of the tenant's (or even the subtenant's) leasehold mortgage.¹¹⁵ The critical feature of the leasehold mortgage from a financing standpoint is that the landlord is able to establish a priority claim over a real estate project and the tenant and the tenant's mortgagee (frequently a construction lender) agree that the landlord will be paid first. This enables shopping center developers to induce land owners to provide land on a "time payment" arrangement for a relatively long lease term. Since Chinese leaseholds cannot be mortgaged, such devices are not possible in China, at least in the traditional form used in America.

Civil law texts, however, have not specifically considered the device of a leasehold mortgage, but have only theoretically classified lease contracts as "credit rights."¹¹⁶ It may thus be possible to convince Chinese lawmakers to recognize the validity of security interests in tenant leasehold estates in the future.

Further, there are some exceptions to the rule that prohibit the mortgage of leasehold interests. Certain leasing contracts entered into by the state with firms formed by the merger or reorganization of former state-owned enterprises, for example, may involve the mortgage of a leasehold interest. In some cases, the state will take back an allocated land use right of an old state-owned enterprise and lease the land to a new organization. Buildings or other improvements on the leasehold land are mortgageable, and, upon foreclosure, the land lease contract can be transferred, along with the buildings or other improvements.¹¹⁷ This makes the leasehold land *de facto* mortgageable.

Similarly, there is some ambiguity about the impact of a mortgage on the landlord's interest. The landlord's interest, if it is a land use right, is a right *in rem* and can be mortgaged. But does the mortgagee obtain an interest that has priority over subsequent leases by the mortgagor? In America, absent special contractual arrangements, the mortgagee can "foreclose away" burdensome leases that arise subsequent to the mortgage.¹¹⁸ Chinese foreclosure law and lease law are unclear on this point. The standard rule is that a sale of the landlord's interest does not

¹¹⁵ For a general discussion of American leasehold mortgage techniques, see MICHAEL T. MADISON & JEFFRY R. DWYER, *THE LAW OF REAL ESTATE FINANCING* ch.7 (1999).

¹¹⁶ This is clear from the General Principles of Civil Law, which put contract rights in the category of creditor's rights. See General Principles of Civil Law, *supra* note 10, arts. 84-93.

¹¹⁷ Provisions on Allocated Land Use Rights, *supra* note 2, art. 3.

¹¹⁸ MADISON & DWYER, *supra* note 115, at 12.36-38.

terminate a lease.¹¹⁹ This, of course, is also the rule in America. The American mortgagee, however, is not the same as an ordinary buyer when the mortgagee's rights arise prior to the lease.¹²⁰ If China does not recognize the priority interest of the mortgagee in this circumstance, it will sacrifice another important potential financing option for real estate developers.¹²¹

E. *Presale Interests*

If the owner of a building wishes to engage in the presale of all or part of the building, which is a common practice in China,¹²² and the presale purchaser wishes to borrow money to fund the consideration, the purchaser can grant a mortgage on the pre-purchased property. Such a mortgage is not a classic mortgage under Chinese law. Two points about this situation are worth noting. First, the presale right is not a right *in rem*, but only a credit right. Thus, the creditor's interest does not attach to a right *in rem*. There is, however, authority for the proposition that a presale right is in fact a right *in rem* because it is a contract right to acquire a right *in rem*.¹²³ Second, similar to the "title theory" in common law, a mortgage in China is viewed as a kind of ownership of the property secured. As such, a mortgage on a presale interest, which may not constitute ownership, has a special character and is given the special name *anjie*.¹²⁴ China recognized this concept before the Communist Party came to power in 1949, but it has begun to appear again only in the 1990's.¹²⁵

The *anjie* concept has taken hold recently because of the rapid development of residential apartment complexes as part of China's housing reforms. Such projects commonly are financed through pre-leasing or presale to companies or other entities either for use by their employees or for

¹¹⁹ Chengshi Fangwu Zulin Guanli Banfa [Measures on the Administration of Urban Building Leasing] (issued May 9, 1995) art. 11, *reprinted and translated as* Administration of the Leasing of Urban Premises Procedures, in 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 4110/95.05.09 (1997).

¹²⁰ In this case, unless the American mortgagee has agreed to a subordination, attornment, and non-disturbance agreement, the mortgagee can terminate the lease through foreclosure. See MADISON & DWYER, *supra* note 115.

¹²¹ Unfortunately, the Security Law does not give the mortgagee a priority interest in this circumstance.

¹²² One issue raised here is that the Security Law requires presale proceeds to be used to retire any mortgage placed on the property by the developer or seller. This requirement, if it cannot be waived, may dampen presale activity on properties that are not equity financed.

¹²³ XU MINGYUE, *DIYA YANJIU* [STUDIES ON MORTGAGES] 46 (1998).

¹²⁴ HE MEIHUAN, XIANGGANG DANBAOFA [SECURITY LAW IN HONG KONG] 181 (1997). This term is one used in Hong Kong to describe the interest.

¹²⁵ Lu Qiong, Fangdichan Anjie Yanjiu [Studies on the *Anjie* System] (1999) (unpublished LL.M. thesis, Peking University (China)) (on file with authors).

leasing to other companies or individuals on a unit by unit basis.¹²⁶ The lender will require a guarantee from the developers (the sellers of the presale right) as well as the signature of the presale purchaser.¹²⁷ If the project is not completed, then the mortgagee will have no value because the land use right will be forfeited. Further, the developer's timely and workmanlike performance also will be more assured if the developer guarantees the purchaser's loan.

The mortgage on the presale interest can be recorded, since the presale contract is recorded.¹²⁸ The recording is entered in the same records that are used for registration of *in rem* interests, but is not a formal registration.¹²⁹ Registration is a requirement for the validity of any *in rem* interest in land.¹³⁰

Following completion of the project, the purchaser and the developer will register the purchaser's land use rights. The mortgage on the presale contract, however, will obligate the seller to deliver the registration certificates to the mortgagees. At this point the mortgage will be re-registered on the new land use right and the developer's guarantee will be released.

F. *Improvements to Mortgaged Property*

An important distinction between Chinese and American mortgage law is that physical improvements to the mortgaged property made subsequent to the mortgage, even buildings fixed to the land, are not covered by the Chinese mortgage.¹³¹ In contrast, in the United States, improvements to the mortgaged property and fixtures added after the mortgage arises accrete automatically to the real property security.¹³² In China, the property may still be foreclosed in accordance with the pre-existing mortgage, but the value of the improvements built later will be deducted from the foreclosure price and paid to the mortgagor or others entitled to the improvements.¹³³

¹²⁶ *Id.* A leasehold estate probably cannot be mortgaged, so only mortgages on presale rights are discussed here.

¹²⁷ *Id.*

¹²⁸ Chengshi Shangpinfang Yushou Guanli Banfa [Administration of the Presale of Urban Commodity Buildings Procedures] (issued Nov. 15, 1994) art. 10, *reprinted and translated in* 4 CHINA L. REFERENCE, *supra* note 2, Ref. No. 41100/94.11.15.

¹²⁹ The Urban Mortgages Measures provide for the interim recording of such mortgages. Urban Mortgage Measures, *supra* note 8, art. 34. When the ultimate land use certificate is issued to the seller and then to the buyer, the mortgage on the buyer's interest must be registered.

¹³⁰ *See infra* Part VIII.

¹³¹ Urban Real Estate Law, *supra* note 2, art. 51.

¹³² *See generally* POWELL ON REAL PROPERTY § 37.13 (1999).

¹³³ Urban Real Estate Law, *supra* note 2, art. 51.

G. Restrictions on Mortgaging Certain Interests

The Security Law prohibits the mortgage of some interests.¹³⁴ One provision prohibits mortgages on land ownership.¹³⁵ Presumably, the purpose of this language is to limit mortgages on collective-owned agricultural property.¹³⁶ A second provision prohibits the mortgage of land use rights on collective-owned land, including land use rights related to a homestead, garden, or to the "household responsibility system."¹³⁷

There are exceptions to these prohibitions. If a township enterprise holds an allocated land use right to land that is collective-owned and the enterprise also owns buildings on that land, it can grant a mortgage on those buildings.¹³⁸ Necessarily, of course, the mortgage on the buildings requires the existence of some mortgageable right in the land itself. Consequently, such mortgages in fact, if not in law, are mortgages on the land use right. Recent regulations acknowledge this fact by requiring that there be an appraisal of the value of the underlying land at the time of the registration of the mortgage so that there will be a basis for charging the mortgagee for the conversion of the allocated right to a granted right if and when it becomes necessary to foreclose.¹³⁹ There are similar provisions providing for the mortgage, appraisal, and "conversion" upon foreclosure of "wasteland"¹⁴⁰ that a collective has obtained from the state.¹⁴¹ Presumably, such land is not fundamental to a collective's social responsibility to oversee the use of agricultural resources.¹⁴²

¹³⁴ Security Law, *supra* note 8, art. 37. In addition to the prohibitions listed above, the Security Law bars mortgages on condemned property, property seized for debt collection (such as for nonpayment of taxes), property as to which ownership is uncertain, or other properties as to which there is a specific prohibition. *Id.*

¹³⁵ *Id.* art. 37(1).

¹³⁶ *Id.* art. 37(2).

¹³⁷ *Id.*

¹³⁸ *Id.* art. 36.

¹³⁹ Mortgage Registration Circular, *supra* note 54, art. 2.

¹⁴⁰ According to the Mortgage Registration Circular, wasteland is property not suitable for agriculture (such as beaches or mountainous regions). *Id.*

¹⁴¹ Such interests technically are not land use rights at all, but constitute ownership of the wasteland. Nevertheless, the procedures followed upon foreclosure are similar to those for conversion of an allocated land use right to a granted land use right.

¹⁴² Although collective land use rights in these cases are mortgageable, the utility of such a mortgage is somewhat questionable, as the character of the use restrictions on the land use right likely are to be such that only the mortgagor can perform those uses. The Security Law provides that simple foreclosure does not alter these use restrictions. Additional official consent must be obtained to alter the uses or to obtain state consent for the foreclosure sale purchaser to carry them out. Security Law, *supra* note 8, art. 55.

Land used for nonprofit social welfare purposes such as schools, nurseries, and medical facilities cannot be mortgaged.¹⁴³ Typically, rights to these lands are allocated land use rights. Land use rights held by such social welfare institutions that are used for revenue-producing facilities (to supplement the budgets of such institutions)¹⁴⁴ may be mortgaged, but the mortgagee must be aware of the limitations on the use of such property contained in the Regulations on the Management of State-owned Assets.¹⁴⁵

Several other types of property may not be mortgaged in China. The Urban Mortgage Measures prohibit mortgages on city infrastructure, buildings protected by historical preservation policies, properties of special social significance such as public monuments, and property scheduled for redevelopment.¹⁴⁶ Finally, as noted above, tenant leasehold estates cannot be the subject of a mortgage.¹⁴⁷

VII. THE MORTGAGE DEBT

A. *General Terms*

Most Chinese mortgage loans are evidenced by a loan agreement that is not in the form of the classic note instrument seen in some American lending contexts. These instruments, unlike those in America, normally are not negotiable notes. China does apply the concept of negotiability in connection with bills of exchange, promissory notes, and checks,¹⁴⁸ but this concept does not apply to the loan agreements currently used for mortgage loans.

B. *Loan Term*

Loans in China are divided into short-term loans (loans with maturity of one year or less), medium-term loans (loans with maturity of more than

¹⁴³ *Id.* art. 37(3).

¹⁴⁴ As noted elsewhere, there is some doubt as to whether such institutions could change the uses for which their property was allocated and whether they might forfeit the property if they failed to use it for the designated purpose. Thus, as a technical matter, only a small amount of institutional property falls within the provisions of the Security Law. As a practical matter, however, it is not uncommon for public institutions to divert some of the property designated for institutional use to other uses with the tacit consent of local land use authorities.

¹⁴⁵ Urban Mortgage Measures, *supra* note 8, art. 13.

¹⁴⁶ *Id.* art. 8.

¹⁴⁷ See *supra* notes 114-121 and accompanying text.

¹⁴⁸ Zhonghua Renmin Gongheguo Piaojufa [Law of the People's Republic of China on Negotiable Instruments] (adopted May 10, 1995), translated in LAWS OF THE PEOPLES REPUBLIC OF CHINA 1995 209-228 (1996).

one year but less than or equal to five years) and long-term loans (loans with maturity of more than five years).¹⁴⁹ According to the General Provisions on Lending, the terms of a loan should be determined through negotiation by the borrower and lender and should be based on the borrower's production cycle and repayment capability and the lender's capacity to provide money.¹⁵⁰ Article 11 of the General Provisions on Lending states that banks cannot issue loans with a term of longer than ten years.¹⁵¹ Article 11 also provides, however, that the maximum term of a "proprietary loan"¹⁵² may exceed ten years, as long as such loans are reported to the PBOC.¹⁵³

The PBOC has issued regulations¹⁵⁴ that permit loans for housing to have a maximum term of twenty years¹⁵⁵ and level debt service payment arrangements on these loans.¹⁵⁶ The Contract Law provides that where the parties set no term, the borrower "may return the money at any time, and the lender may urge the borrower to return it during a reasonable time limit."¹⁵⁷ A mortgage loan, in any event, cannot exceed the term of the land use right to which it relates.¹⁵⁸

C. Interest

Mortgage interest rates on loans must fall within a range set periodically by the PBOC.¹⁵⁹ The PBOC's rate schedule includes different rates for different risks.¹⁶⁰ The PBOC usually permits lower interest rates

¹⁴⁹ General Provisions on Lending, *supra* note 45, art. 8.

¹⁵⁰ *Id.* art. 11.

¹⁵¹ *Id.*

¹⁵² A "proprietary loan" is defined as any loan provided by a lender at its discretion with legal monetary resources. *Id.* art. 7.

¹⁵³ *Id.* art. 11.

¹⁵⁴ Individual Housing Loan Measures, *supra* note 14, art. 10.

¹⁵⁵ The upper-term limit on an individual home mortgage was extended from 20 to 30 years. See *China's Central Bank Extends Mortgage Period, Cuts Rates to Stimulate Home Sales*, available in Chinaonline (visited Nov. 10, 1999) <<http://www.chinaonline.com/topstories/delivery/c9092115.asp>>.

¹⁵⁶ With regard to housing loans, for loans with maturity of one year or less, interest is paid off in a lump sum along with the principle at the end of the term. For loans with maturity of over one year, principal and interest is paid monthly. Individual Housing Loan Measures, *supra* note 14, art. 11.

¹⁵⁷ Contract Law, *supra* note 27, art. 206. Article 61 indicates that trade custom may be used to clarify ambiguities or gaps in contract terms. *Id.* art. 61.

¹⁵⁸ Urban Mortgage Measures, *supra* note 8, art. 18.

¹⁵⁹ Contract Law, *supra* note 27, art. 204; Commercial Banking Law, *supra* note 24, art. 38.

¹⁶⁰ Interest rate control has been a dominant feature of China's financial system. Before economic reform, bank interest rates in China remained at low levels with very few brackets and were always fixed for long periods of time. Since reform began, however, interest rate policy has gone through adjustments that have enabled interest rates to function as a lever in regulating the supply and demand for funds.

Despite adjustment and relaxation, interest rates continue to be set administratively by the People's Bank of China ("PBOC"), subject to the approval of the State Council. In 1985, with the approval of the

for working capital loans than for fixed asset loans.¹⁶¹ It does permit negotiation of a lower rate for working capital real estate mortgage loans, however.¹⁶² The Contract Law prohibits the use of prepaid interest.¹⁶³ If the lender deducts prepaid interest, it can collect interest only on the monies actually advanced to the borrower. If a loan agreement between natural persons does not provide for interest, it is assumed that no interest is intended.¹⁶⁴

D. *Prepayment*

Loans are assumed to include a prepayment privilege unless such a privilege is restricted by contract.¹⁶⁵ There is little experience with prepayment restrictions in the modern Chinese economy, as China has a significant capital shortage and prepaid money can be reloaned very quickly.

State Council, the PBOC adjusted some of the deposit and lending interest rates. According to a circular issued by the PBOC, state specialized banks must comply with the interest rate policy and interest rate criteria set by the PBOC. See *Zhongguo Renmin Yinhang Guanyu Tiaozheng Bufeng Chunkuan Daikuan Lilu De Baogao* [Report of the People's Bank of China on Adjusting Some Deposit and Loan Interest Rates] (approved Mar. 14, 1985) art. 6, reprinted in *ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO* [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Apr. 20, 1985, at 262-66.

The 1986 Interim Regulations on Bank Administration provided that, except for inter-bank lending interest rates, interest rates should be set by the headquarters of the PBOC. *Zhonghua Renmin Gongheguo Yinhang Guanli Zhanxing Tiaoli* [Interim Regulations on Bank Administration of the People's Republic of China] (issued Jan. 7, 1986) arts. 42, 44-45, reprinted in *ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO* [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Jan. 30, 1986, at 3-10. Accordingly, interest rate management falls into three different categories. The first class, the unified interest rate, is used mainly by specialized banks, although a different rate for working capital may be floated. The second class of interest rates floats according to the market. Included in this class are the inter-bank lending rate and other rates, as well as the rate for rural credit cooperatives. The third class of interest rates floats within limits set by the PBOC. Liu Hongru, *Developments in the Reform of China's Banking and Financial System*, 2 J. CHINESE L. 323, 353 (1988). The Commercial Banking Law, while providing that a commercial bank shall operate and assume civil responsibilities independently, reiterated that the commercial banks shall fix their interest rates for deposits and loans pursuant to the ceiling and floor of interest rates defined by the PBOC.

Interest rates set by the non-bank financial institutions and urban credit cooperatives are adjusted according to demand and supply. See, e.g., Xie Ping, *Toward a Market-Oriented Interest Rate Policy in the Transformation of China's Economy*, in *INTEREST RATE LIBERALIZATION AND MONEY MARKET DEVELOPMENT* 145, 151 (Mehran Hassanali et al. eds., 1996).

¹⁶¹ See, e.g., *Zhongguo Renmin Yinhang Guanyu Yansu Jinrong Jilu Yanjin Feifa Tigao Lilu de Gonggao* [Bulletin of the People's Bank of China on Tightening Up Financial Discipline and Banning the Illegal Raising of Interest Rates] (issued Feb. 8, 1996), available in *ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO* [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA], Mar. 4, 1996, at 116-19.

¹⁶² *Id.*

¹⁶³ Contract Law, *supra* note 27, art. 200.

¹⁶⁴ *Id.* art. 211.

¹⁶⁵ *Id.* art. 208.

Some lenders are beginning to require provisions that restrict the right to prepay without advance notice, but do not prohibit or penalize prepayment altogether.¹⁶⁶

E. A Special Problem Regarding the Amount of Loans—Construction Loans

The Security Law provides that mortgages may secure only an amount that does not exceed the value of the real estate given as security at the time of the mortgage.¹⁶⁷ This obviously creates some difficulty for construction loans. Typically, lenders in America make a loan based on the value of property once it is improved, not on its value at the time of the initial mortgage.¹⁶⁸ It seems clear that Chinese lawmakers intended to preclude such practices in China. The 1997 Urban Mortgage Measures contain a provision specifically designed to address the issue of loans for construction. That provision indicates that the only security that will pass under a mortgage for construction on property is the value of the land use right and improvements already existing on the property at the time of the loan.¹⁶⁹ The value of the real estate for purposes of these mortgage provisions may be determined by negotiation or by appraisal.¹⁷⁰ The value of the land use right portion of the real estate, however, must be determined by appraisal.¹⁷¹

F. Future Advances

By law, Chinese mortgages secure advances for various claims of the mortgagee arising out of a default. The Security Law expressly states that, unless the contract provides otherwise, the mortgage will secure the principle, interest, any penalties set forth in the contract for breach, general damages for breach, and the costs of foreclosure.¹⁷² When the debt is paid, the mortgage is invalid.¹⁷³

¹⁶⁶ Under these agreements, if the borrower does not make the prepayment that he notifies the lender about, the lender may exact an additional penalty for the borrower's failure to carry out the prepayment.

¹⁶⁷ Security Law, *supra* note 8, art. 35.

¹⁶⁸ MADISON & DWYER, *supra* note 115, at 6-11.

¹⁶⁹ Urban Mortgage Measures, *supra* note 8, art. 3. The Urban Mortgage Measures set forth special provisions that must appear in a construction loan mortgage contract. *Id.* art. 28.

¹⁷⁰ *Id.* art. 22.

¹⁷¹ Mortgage Registration Circular, *supra* note 54, art. 2.

¹⁷² Security Law, *supra* note 8, art. 46.

¹⁷³ *Id.* art. 52.

Chinese law does recognize future advance mortgages¹⁷⁴ if the contract sets a maximum amount.¹⁷⁵ A mortgage can secure an open account.¹⁷⁶ Priority dates from when the future advance agreement comes into effect, regardless of the time the advances are made. Presumably, the maximum amount cannot exceed the value of the property at the time the mortgage is set.¹⁷⁷

In this area, Chinese law is a step ahead of American law. American common law has had great difficulty with the issue of the priority of future advance mortgages. The new Restatement (Third) of Property—Mortgages proposes a rule similar to the Chinese rule. Under the Restatement rule, future advances take priority from the time of the recording of the future advance agreement.¹⁷⁸ A few states have reached the same result by statute.¹⁷⁹ Generally, however, American law that provides for such priority requires that the mortgage agreement contain a stated maximum amount.¹⁸⁰

VIII. REGISTRATION AND PRIORITY

In China the mortgagee's rights arise upon registration.¹⁸¹ Under the recent Circular on Issues Concerning the Registration of Mortgages on Land Use Rights, registration is required for the creation, release, or modification of a mortgage.¹⁸² A mortgage on real property is not effective without registration,¹⁸³ and a mortgage on a land use right that is not registered will not be protected by law.¹⁸⁴ This mirrors the language of Article 41 of the Security Law.¹⁸⁵ Thus, if the holder of a land use right grants a mortgage to A, but A fails to register promptly, and then the holder grants a mortgage to

¹⁷⁴ Security Law, *supra* note 8, art. 59.

¹⁷⁵ The Security Law provides that lenders with future advance mortgages cannot assign to other lenders the right to make secured loans pursuant to the future advance secured rights of the original lender. *Id.* art. 61.

¹⁷⁶ *Id.* art. 60.

¹⁷⁷ See *supra* notes 167-171 and accompanying text.

¹⁷⁸ RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 2.1 (1997).

¹⁷⁹ *Id.* at 56 (chart summarizing future advances statutes).

¹⁸⁰ *Id.*

¹⁸¹ Article 30 of the Urban Mortgage Measures requires that the parties apply to register the mortgage within 30 days of its execution. Urban Mortgage Measures, *supra* note 8, art. 30. Article 33 requires the registration agency to respond within 15 days of application. *Id.* art. 33.

¹⁸² Mortgage Registration Circular, *supra* note 54, art. 1. See also Articles 41 and 42 of the Security Law, which require the registration of mortgages on real property. Security Law, *supra* note 8, arts. 41-42.

¹⁸³ Urban Mortgage Measures, *supra* note 8, art. 31.

¹⁸⁴ Compare the more general provisions of the Security Law, which permit contracts for mortgages other than real estate mortgages to be valid upon signature, even without registration. Security Law, *supra* note 8, art. 43. Registration for such contracts is permitted but not required.

¹⁸⁵ *Id.* art. 41.

B, who registers before A, B will have priority, even if B was aware of A at the time of B's mortgage.

More than one mortgage can attach to a single land use right.¹⁸⁶ Each successive mortgagee will have priority as of registration.¹⁸⁷ When a mortgage is paid or otherwise canceled or amended, the parties are required to provide for registration of the changed status of the mortgage.¹⁸⁸

As to improved real property, two mortgages must be registered—one on the land use right and another on the separate ownership right of the building.¹⁸⁹ Although these interests are technically distinct, they can be foreclosed together in one action.¹⁹⁰ Basically, registration validates the right to foreclose if and when there is a default on the secured loan and to the right to proceed against the property with the priority existing as of the date of registration.

Although debt instruments can be assigned in China,¹⁹¹ the assignee must change the registration of the mortgage to be confident of its right to exercise the mortgagee's rights.¹⁹² Thus, the typical rule in American law that the "mortgage follows the note"¹⁹³ is somewhat modified by registration practices in China.

Registration does provide constructive notice of the mortgagee's right. Nevertheless, the mortgagor has an affirmative obligation to notify any subsequent transferees, mortgagees, or lessees of the land use right of the existence of a mortgage.¹⁹⁴ Recourse for non-notification runs only against

¹⁸⁶ Security Law, *supra* note 8, arts. 42-43.

¹⁸⁷ Urban Mortgage Measures, *supra* note 8, art. 43.

¹⁸⁸ *Id.* art. 35; 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 38.

¹⁸⁹ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 35.

¹⁹⁰ The technical distinction between land use rights and improvements on the land can be clearly observed in the provisions of the Urban Real Estate Law. This law provides separately for the transfer, lease, or mortgage of land use rights, and for the transfer, lease, or mortgage of buildings. The distinction is evidenced by the registration practices as well. In most areas of China, there are different registers for land use rights and for ownership of buildings. This technical distinction, however, should not be a substantial obstacle to the development of real estate in China because, according to the law, improvements on the land must be transferred and mortgaged along with the land use rights and *vice versa*. 1990 Regulations on Granting Land Use Rights, *supra* note 2, arts. 23, 33; Security Law, *supra* note 8, art. 36.

¹⁹¹ Contract Law, *supra* note 27, art. 79.

¹⁹² See *supra* note 182 and accompanying text.

¹⁹³ See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 334-37 (3d ed. 1994) and authorities cited.

¹⁹⁴ Registration publicizes and validates the mortgagor's rights. As an *in rem* right, the mortgage is superior to a creditor's right. This is why subsequent transferees, mortgagees, or lessees of the land use right do not have recourse against the existing mortgagee.

The mortgagor's obligation to notify arises mainly from Article 42 of the Contract Law, which obliges contracting parties to act in good faith when concluding a contract. Contract Law, *supra* note 27, art. 42. The notification obligation is also provided for in the Security Law. Security Law, *supra* note 8, art. 49.

the mortgagor.¹⁹⁵ The law voids the transfer of an interest in the mortgaged property without the mortgagee's consent.¹⁹⁶

Mortgages on presale contracts must be recorded and certain prerequisites must be met.¹⁹⁷ It is possible for a mortgage to be acquired on a buyer's presale right. Although it is only a credit right and credit rights normally are not mortgageable, the law definitely recognizes the ability of a mortgagee to obtain such an interest.¹⁹⁸

IX. TRANSFER OF MORTGAGEE'S RIGHTS

Debt instruments can be assigned in China.¹⁹⁹ Upon the transfer of a mortgage debt, the assignor and assignee must apply for registration of the changed ownership²⁰⁰ and notify the mortgagor.²⁰¹ Consequently, an assignee will not be able to rely upon the assignment to establish its rights under the mortgage. Instead, the assignee's ownership must be registered. The Security Law provides that a mortgage cannot be assigned independent of the credit right that it secures and that it cannot be used as security for a debt.²⁰² This prohibition probably applies when a mortgagee attempts to use the mortgage instrument itself as an independent debt instrument rather than as a simple security instrument.

When the secured debt is evidenced by a separate instrument, a security interest can be created in that instrument.²⁰³ At present, no real secondary market appears to exist in Chinese finance. The law does not prohibit a Chinese bank from assigning its rights in a loan after it has made the loan, but the bank assignor may be able to transfer the loan rights to another bank or properly licensed non-bank financial institution.²⁰⁴ Details

¹⁹⁵ *Id.*

¹⁹⁶ Urban Mortgage Measures, *supra* note 8, art. 49.

¹⁹⁷ Urban Real Estate Law, *supra* note 2, art. 44; Administration of the Presale of Urban Commodity Buildings Procedures, *supra* note 128, arts. 5-6.

¹⁹⁸ The Urban Mortgage Measures provide for the interim registration of such mortgages. Urban Mortgage Measures, *supra* note 8, art. 34. When the ultimate land use certificate is issued to the seller and then to the buyer, the mortgage on the buyer's interest must be re-registered.

¹⁹⁹ Contract Law, *supra* note 27, art. 79.

²⁰⁰ Urban Mortgage Measures, *supra* note 8, art. 37.

²⁰¹ There is no requirement that the mortgagor consent to the transfer. The only requirement is that the mortgagor must be notified. *Id.*

²⁰² Security Law, *supra* note 8, art. 50.

²⁰³ The Security Law specifically permits the use of a promissory note as a security for a debt. *Id.* art. 75.

²⁰⁴ In China, parties engaging in the loan business must be approved by the People's Bank of China and granted a License for Financial Institution Legal Person or a License for Financial Institutional Operation by the People's Bank of China. They must be registered with the Administration for Industry and Commerce. General Provisions on Lending, *supra* note 45, art. 21.

of such assignments, such as perfection of the assignee's rights, are uncertain because the practice has not developed. Theoretically, however, there is a basis for a concept of "negotiability" in that the transferee might be able to take its interest in the assignment free of defenses of the borrower against the transferor.

X. TRANSFER OF MORTGAGOR'S RIGHTS

A. *Basic Transfer Restriction*

Article 49 of the Security Act requires that the mortgagor notify the mortgagee prior to any transfer of the property.²⁰⁵ The Urban Mortgage Measures provide that the transfer is void if the mortgagee does not affirmatively consent to the transfer in advance.²⁰⁶ The transfer restriction in the Urban Mortgage Measures applies both to the sale of the interest and to the leasing of the property. The language requiring notice prior to the transfer of the real estate does not appear to apply to the creation of junior mortgage interests. Moreover, other provisions of the Security Law contemplate that a junior mortgage may arise, suggesting that the mortgagee has no right to object to such a mortgage.²⁰⁷

B. *Problems With Contracting for the Sale of Mortgaged Property*

1. *The Basic Problem*

Although the prior consent requirement corresponds to mortgage provisions that commonly appear in Western mortgages (known as "due-on-sale" clauses),²⁰⁸ the wording of the provision in the Urban Mortgage Measures creates some difficulty for mortgagors when they wish to sell the property and pay off the existing mortgage.

²⁰⁵ Security Law, *supra* note 8, art. 49.

²⁰⁶ Urban Mortgage Measures, *supra* note 8, art. 49. The Security Law contains language giving the mortgagee the authority to demand additional security if it deems the consideration paid for the transfer to be inadequate. Security Law, *supra* note 8, art. 49. Although the Security Law does not say so specifically, this suggests that if the mortgage debt is not completely paid from the proceeds of the sale of the property, the mortgage nevertheless would be released and the property would be sold to the transferee without the mortgage, while the mortgagee would take new security from the original mortgagor.

²⁰⁷ Security Law, *supra* note 8, art. 35.

²⁰⁸ This device enjoys a special protection in America under pre-emptive federal legislation. See generally NELSON & WHITMAN, *supra* note 193, at 294-337.

Under the Urban Mortgage Measures, there is some possibility that the contract by which the mortgagor has agreed to sell the property would not be viewed as binding unless and until the mortgagee approves the sale.²⁰⁹ This is because until consent is obtained, the contract fails to comply with the mandatory provisions of the Urban Mortgage Measures, which in a broad sense constitute part of the laws of the People's Republic of China.²¹⁰ Thus, the contingency that the mortgagee must approve of the transfer leaves all sales contracts in a state of uncertainty, even when the contract provides that the mortgagee will be paid off at closing. This is important because of the prevailing practice in China of preselling substantial portions of a property prior to the completion of a project.²¹¹ Until the project is substantially completed, it may be impossible for the holder of the land use right to transfer the project. Nevertheless, the holder often commits to contracts to sell in exchange for consideration, which provide additional capital to complete the project.

It is possible that Chinese authorities ultimately will construe the provisions of the Security Act and the Urban Mortgage Measures to apply only to actual transfers of land use rights and not to presales. Even so, the presale purchaser likely will gain little comfort from such a ruling unless the mortgagee consents to the sale. If the mortgagee has the right to refuse to consent to the sale even when the mortgagee will be fully paid, there would still be no certainty that the mortgagor would be able to deliver good title.

2. *Partial Interpretive Solution*

It seems likely that Chinese authorities will not view a contract of sale as void and will deny the mortgagee the right to refuse to consent to a sale if the parties commit to use the presale proceeds to pay down the mortgage debt and if the mortgage is retired completely upon consummation of the sale. This conclusion is based upon no more than a logical examination of the situation. If the mortgage is completely retired, the mortgagee has no legitimate motive to hinder the sale. To permit the mortgagee to do so would unnecessarily impede the operation of the marketplace. Even a legal system inclined to slant its laws in favor of institutional lenders must recognize that vesting unnecessary authority over marketplace transactions

²⁰⁹ Urban Mortgage Measures, *supra* note 8, art. 49.

²¹⁰ A contract violating the provisions of laws and administrative regulations is null and void. Contract Law, *supra* note 27, art. 52.

²¹¹ Lu Qiong, *supra* note 125.

in parties with interests that are not affected by such transactions will lead to inefficiency and possibly to extortion.

In fact, the Security Law requires any proceeds from the sale of the mortgagor's land use rights to be applied to the mortgage debt, whether or not the debt otherwise is due.²¹² The authors believe that the purpose of this provision is to further implement China's anti-speculation policies. The notion is that in the vast majority of cases there will be no transfer until development of the parcel has been completed. At that point, to permit the mortgagee to retain the benefits of a mortgage loan on the property after disposal of the property would permit speculation in the security value of the property. But the fact that the mortgagee's interest must, as a matter of law, be retired from the sale proceeds of a real estate sale underscores the compelling nature of the principle that mortgagees should not have the right to impede the sale.²¹³

3. *Substitute Security and the Issue of Defeasance*

The Chinese mortgagee may claim a stronger interest in controlling the sale of property subject to a mortgage when the proceeds of the sale are insufficient to retire the mortgage. The proceeds may be insufficient either because the property has declined in value or because the sale involves only a portion of the mortgage property. In the United States, there was a lengthy legal battle in the 1970s over whether the mortgagee's attempts to pursue its own economic interests by enforcing its right to control the sale of mortgaged property amounted to an unlawful restraint on alienation.²¹⁴ This battle ultimately was resolved by pre-emptive Congressional action that authorized lenders to withhold consent to such sales except under certain narrowly defined circumstances.²¹⁵ Thus, even by American standards, giving the lender some control over the sale of mortgaged real estate is legitimate. Here too, however, the American mortgagee's rights are limited

²¹² Security Law, *supra* note 8, art. 49; Urban Mortgage Measures, *supra* note 8, art. 38.

²¹³ Of course, mortgagees should be able to collect any prepayment fees provided for in the instruments to protect themselves from the economic consequences of loss of the mortgage loan.

²¹⁴ Prior to the Congressional pre-emption of "due-on-sale" clause regulation, there was about a decade of judicial debate about the legitimacy of the due-on-sale clause. A majority of the jurisdictions recognized the clause as valid, but a minority of courts, among them the California Supreme Court, viewed the clause as invalid when used for the purpose of maintaining a higher return on the mortgagee's portfolio. The issue came to the fore because of, and was exacerbated by, a concurrent period of extremely volatile interest rates. The story is told in a condensed fashion in NELSON & WHITMAN, *supra* note 193, at 301-08.

²¹⁵ *Id.*

to demanding payment of the mortgage in full at the time of sale and do not permit mortgagees to invalidate the sale by refusing consent.²¹⁶

Except in periods of severe market decline, the real bite of the Chinese mortgagee's right will be felt by commercial mortgagors wishing to sell only a portion of the mortgaged property without paying off the mortgage in full. Under such circumstances, the property owner may wish to retain the benefits of an attractive mortgage loan or may be concerned about being forced to pay a high prepayment penalty. Furthermore, under the current system in China, the mortgagor may be concerned that the mortgagee can prevent negotiations on the entire sale by refusing consent.

Chinese law may provide some assistance to mortgagors in these circumstances. This assistance takes the form of a defeasance right. A defeasance is a termination of the security interest of the mortgagee without the payment of the debt. American mortgagors usually lack such a right because it is not provided for by law or because the mortgagors fail to establish such a right by contract.

At least some Chinese commentators have suggested that the statutory scheme for the sale of mortgaged property contemplates that the mortgagee's consent to the sale of the property is a consent to sale free and clear of the mortgage.²¹⁷ Thus, even if the mortgage is not paid off completely, the buyer, whether a buyer of part or all of the security, would take free of the mortgage.

The Security Law allows the mortgagee to condition its approval of the sale on the provision of additional security by the mortgagor.²¹⁸ This language is helpful to the mortgagee, of course, but seems somewhat inconsistent with the argument by the mortgagee that it has a general right to refuse to consent to a sale on any basis. It may be that a mortgagor will be able to argue that if it *does* provide adequate substitute security, the mortgagee *must* agree to the transfer. This result appears to be consistent with the general principles of good faith that are part of the Contract Law and have been long established in Chinese civil law.²¹⁹

²¹⁶ See *supra* note 208 and accompanying text.

²¹⁷ DANBAOFA LIJIE YU SHIYONG [EXAMPLES AND APPLICATIONS OF THE SECURITY LAW] 378-381 (Kong Xiangjun ed., 1996).

²¹⁸ Security Law, *supra* note 8, art. 49. Note that this provision of the Security Law, like most of the provisions of the law, does not apply exclusively to real estate mortgages. There is always the possibility that the language really is intended for application in other situations.

²¹⁹ The principle of good faith is established in the General Principles of Civil Law as one of the basic principles of Chinese civil law. General Principles of Civil Law, *supra* note 10, art. 4.

The Contract Law applies the principle to the whole life of a contractual relationship. According to the Contract Law, courts may impose special duties upon the parties to a contractual relationship to deal with each other fairly during the negotiation and performance of the contract and even thereafter. Contract

Permitting a mortgagor to accomplish a defeasance by providing substitute security would resolve for China an important issue that has bedeviled parties to large real estate transactions in the United States. Sophisticated commercial mortgagors try to negotiate for a "partial defeasance" right to permit them to respond to market opportunities without forfeiting the benefits of a desirable mortgage loan. It may not be appropriate, however, to read into the Chinese laws an intent to impose an obligation on the mortgagee to consent after substitute security is provided. If there is no such implied duty to consent, it also seems incongruous to read the consent provisions as a consent to a transfer free of the mortgage. There is nothing specific in the Chinese statutes and regulations that suggests that a land use right cannot be transferred subject to an existing mortgage. Consequently, Chinese law appears to permit such an arrangement when the mortgagee has consented.

4. *Drafting Around the Problem*

In light of all of the uncertainty, it is clear that many mortgagors will want to alter the statutory result in this area by contract, either by providing for an explicit right to sell parcels with complete freedom or under certain objectively determined circumstances. Mortgagors may also try to include language that states that any sale contracts are deemed approved as long as the proceeds of such sales are applied as a prepayment on the mortgage. More likely, however, the mortgagors will want to avoid the mandatory prepayment altogether, both at the time of presale and also at the time of ultimate resale. Instead, mortgagors will prefer to adhere to the original payment schedule. The likelihood that the parties will be successful in contracting around the statutory language is discussed below.²²⁰

If the mortgage were to continue to bind the property after sale, again the mortgagor would prefer that the mortgagee not have unfettered discretion to refuse to approve a transfer. So long as the sale proceeds are used to pay down the mortgage, there are few circumstances in which the mortgagee has a legitimate basis for refusing to consent to a partial sale. In the United States, as indicated, mortgagees often reserve the right to refuse in order to retain the ability to raise the interest rate or exact other

Law, *supra* note 27, arts. 6, 42, 60. Further, the Contract Law states specifically that the courts, in interpreting the contract, will do so under the assumption that the parties intended to act in good faith in performing the contract. *Id.* art. 125. The duty of good faith applies even after the contractual relationship has ended.

²²⁰ See *infra* notes 266-280 and accompanying text.

concessions as payment for their consent. When a mortgagor has bargaining power in China, the mortgagor may want to resist conferring upon the mortgagee the absolute right to refuse consent to transfers when the mortgage is reduced but not paid off.

5. *Contrary Authority in the Urban Mortgage Measures*

Despite the strong language of Article 49 of the Urban Mortgage Measures, which indicates that the mortgagee has a right to control the sale of the mortgaged property, Article 29 of the Measures suggests that a different rule may apply. Article 29 states that if the mortgagee desires that the mortgagor be “limited” from leasing, transferring, or changing the use of the property, the mortgagee should clearly provide for such restrictions in the mortgage contract.²²¹ Obviously, this provision suggests that the mortgagor has the right to lease, transfer, or change the use of the property if the mortgage contract does not prohibit it. One way to reconcile these provisions is to conclude that Article 29 contemplates a situation in which the mortgagee absolutely refuses to permit such transfers under any circumstances. If the contract does not include such language, then the inference would be that the mortgagee retains an approval right, but that it may not have the right to withhold approval under certain circumstances, such as when the mortgage debt is retired from proceeds or when adequate substitute security is provided.

C. *Impact of Transfer on the Original Mortgagor*

If there is a transfer of property subject to a mortgage and the mortgage debt is not retired—such as when the price is inadequate to pay off the debt—there is no reason to believe that such a transfer automatically releases the original debtor from the obligation. The original debt remains, and the transferee is required to register the mortgage in favor of the mortgagee as part of the transfer. Of course, the mortgagee’s consent is necessary for such a transfer, and the right to transfer likely must be purchased. The transferee’s assumption of the debt could be an appropriate “purchase price.”

XI. LEASING OF MORTGAGED PROPERTY

Article 49 of the Urban Mortgage Measures provides that a mortgagor can lease or transfer the mortgaged property with the consent of the

²²¹ Urban Mortgage Measures, *supra* note 8, art. 29.

mortgagee.²²² Article 37 of the Urban Mortgage Measures states that the proceeds of such a lease or transfer shall be paid to the mortgagee as a prepayment.²²³ To the extent this language covers only the transfer of a mortgagor's land use rights, it likely is consistent with Article 49 of the Security Law.²²⁴ But the new impact here is on the lease of the mortgaged property. The language appears to require all lease revenues (the Measures do not clarify whether these are net or gross lease revenues) to be applied as a prepayment on the outstanding mortgage.

A central purpose of much real estate development is to transfer or to lease the property. The whole purpose of borrowing money is to permit the mortgagor to create an economic asset, often a rent-generating economic asset. As long as the mortgagor makes the payments required under the lease, the mortgagor should be permitted to realize the benefits of the economic asset it has created. The provision directing that all lease payments be paid directly to the mortgagee contradicts this fundamental principle of real estate investment.

The authors believe that Chinese lawmakers should interpret Article 37 of the Urban Mortgage Measures to apply only when the property is completely leased under one lease agreement and not when the mortgagor is providing extended leasing services to multiple tenants (such as in an office complex or shopping center context). When Article 37 does apply, it is likely that mortgagors expecting to generate lease revenues will seek contract language altering its effect. The validity of such contract language is discussed below.²²⁵

When property subject to a lease is subsequently mortgaged, the mortgagor has a legal responsibility to inform the mortgagee of the lease and to inform the lessee of the mortgage.²²⁶ The mortgage has no impact on the lease, however, and neither the lessee nor the mortgagee has the right to object to the mortgagor's actions.²²⁷

²²² *Id.* art. 49.

²²³ *Id.* art. 37.

²²⁴ The Security Law does not list any consequences for a transfer without the mortgagee's permission. In contrast, the Urban Mortgage Measures expressly indicate that such transfers (including leases) are void. Urban Mortgage Measures, *supra* note 8, art. 49. To the extent that the Security Law is not read to void unapproved transfers, the Urban Mortgage Measures and the Security Law are inconsistent.

²²⁵ See *infra* notes 266-280 and accompanying text.

²²⁶ Urban Mortgage Measures, *supra* note 8, art. 21.

²²⁷ Security Law, *supra* note 8, art. 48.

XII. CONDITION OF PROPERTY; INSURANCE

A. *Physical Condition of Property*

The Urban Mortgage Measures create a duty on the mortgagor to avoid waste. This duty is quite similar to that borne by mortgagors under typical Western mortgages. The Urban Mortgage Measures confer on the mortgagee a specific right to inspect the property in order to ensure compliance with this duty.²²⁸ Article 36 of the Urban Mortgage Measures states that during the term of the mortgage the mortgagor has a duty to maintain and protect the property, and the mortgagee has the right to supervise how the mortgagor performs this duty.²²⁹

Article 39 of the Urban Mortgage Measures provides that if the property is damaged for reasons unrelated to the mortgagor's conduct, the mortgagor must notify the mortgagee within a reasonable period of time and take the steps necessary to prevent further loss.²³⁰ If the actions of a third party caused the injury, the mortgagee may recover directly from the third party if the mortgagor does not do so and may apply the damages to the reduction of the debt.²³¹ If the mortgagor obtains the proceeds, the mortgagee may require that they be applied to the satisfaction of the mortgage debt, at least to the extent that such damages reflect a diminution in the value of the security.²³² The mortgagee, at least under the language of the Measures, has no further right as a consequence of the damages. If the mortgagor's acts damage the property and reduce its value to an amount less than the value of the loan at the time of injury, the mortgagee has a right to require the mortgagor to restore the property or provide additional security.²³³

B. *Insurance*

Article 23 of the Urban Mortgage Measures indicates that the parties may require the mortgaged property to be insured but does not mandate that they do so.²³⁴ If the parties provide for insurance, however, the Urban Mortgage Measures appear to require that the mortgagor arrange for and pay

²²⁸ Urban Mortgage Measures, *supra* note 8, art. 36.

²²⁹ *Id.*

²³⁰ *Id.* art. 39.

²³¹ *Id.*

²³² Security Law, *supra* note 8, art. 58.

²³³ *Id.* art. 51.

²³⁴ Urban Mortgage Measures, *supra* note 8, art. 23

for the insurance and then transfer the policy to the mortgagee, who will thereafter be the primary beneficiary of any insurance proceeds.²³⁵ If the property is insured and becomes damaged, the mortgagee can collect the proceeds directly from the insurer and apply them to the debt, regardless of whether the damage was caused by the mortgagor.²³⁶ Under these circumstances, the amount of additional property that the mortgagee could require to be mortgaged (assuming the mortgagor was at fault) would be reduced by the amount of the insurance proceeds.

C. *Expanding a Mortgagee's Rights*

The mortgagee may be interested in expanding its rights in the areas considered here, particularly with respect to actions of the mortgagor that have no impact on the physical characteristics of the property but that affect its value. American mortgages contain provisions related to the conduct of the business, protection against senior liens, tax and assessment defaults, compliance with laws, and numerous other terms tailored to the specific risks of the given transaction. As discussed below,²³⁷ there is a significant question as to whether the mortgagee can alter or expand, by contract, the statutory rights relating to physical injury. The laws are silent, however, on the question of economic as opposed to physical injury to the mortgaged property. Consequently, the mortgagee should be able to fashion specific provisions in the mortgage agreement that deal with issues of economic injury.

The Urban Mortgage Measures contain a special provision authorizing the mortgagor and mortgagee to negotiate alternative security measures in the event that the mortgaged property is taken for redevelopment purposes.²³⁸ The mortgagor also has a duty to notify the mortgagee promptly upon receiving notice of any proposed redevelopment activity.²³⁹ There does not appear to be any mandated outcome for these negotiations. Presumably, however, a mortgagor could rely upon the provision to argue that the mortgagee must negotiate in good faith and cannot simply accelerate the mortgage debt when the security is taken for state purposes.

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ See *infra* Part XV.

²³⁸ Urban Mortgage Measures, *supra* note 8, art. 38.

²³⁹ *Id.*

XIII. DEFAULT AND ACCELERATION

Every mortgage on Chinese property should contain provisions that permit a mortgagee to monitor the use of the property to ensure that the property user is meeting the conditions of the land use right.²⁴⁰ Failure to use land as stipulated under a granted or allocated land use right can result in complete forfeiture of the land use right.²⁴¹ This destroys the mortgagee's security interest as well as the finances of the borrower, leading to an almost certain loss for the lender. At the very least, failure to comply with the land use right should be an event of default giving rise to acceleration. This is an area in which it might be possible to draft provisions giving the lender the right to step in and complete development or operate the project. A court might be persuaded to enforce such a right, since the maintenance of the right would appear to be in the public interest.

The 1990 Regulations on Granting Land Use Rights provide specifically for a foreclosure right in the event of default or bankruptcy by the mortgagee and also state that foreclosure can be carried out "in

²⁴⁰ The Contract Law gives the lender the right to monitor loan usage and to invoke acceleration, rescission, or other remedies if the borrower does not use the loan proceeds in accordance with the loan agreement. Contract Law, *supra* note 27, arts. 202-03. These provisions of the Contract Law deal with the use of the *loan proceeds*, however, and not with the use of the property itself. In most cases, the loan proceeds are to be used to develop the property, but this is not universally true. In any event, a wise drafter should include specific provisions dealing with the use of the property in addition to those dealing with the use of the proceeds.

²⁴¹ If the grantee of a granted land use right fails to use the land as designated within two years of the date provided in the contract for commencement of development (which may be different than the date of the grant itself) the state can reclaim the land use right. Urban Real Estate Law, *supra* note 2, art. 25. There is no compensation payable for either the loss of the land use right or the improvements. Delay for even one year in using the land as designated can result in a fine of up to 20% of the fee paid for the land use right. *Id.*

There is some question under recent amendments to the Land Administration Law as to the status of allocated land use rights when the user has stopped using the land for the purpose it was allocated. Prior law specified that if the user failed to carry out the identified use for more than two years or changed the use of the land without the approval of the Bureau of Land Administration, the state could reclaim the land. See the original version of the Land Administration Law, which was promulgated in 1986. Zhonghua Renmin Gongheguo Tudi Guanlifa [Land Administration Law] (1986) art. 19, *translated in* LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1983-1986 258-70 (1987); 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 47.

The 1998 amendments to the Land Administration Law deleted those articles that related to the two-year interruption in use. The relevant language now provides that the state can reclaim the property, with no compensation for loss of the land use right, if the user "ceases to use the allocated land use right" for reasons other than those listed elsewhere in the statute. Land Administration Law, *supra* note 6, art. 58. The Regulations Concerning the Protection of Primary Agricultural Land, however, provide that non-agricultural land use rights in land that was primarily agricultural land shall be forfeited without compensation from the people's government at or above the county level if there are two years of interruption in the use of the land. Jiben Nongtian Baohu Tiaoli [Regulations Concerning the Protection of Primary Agricultural Land] (effective Jan. 1, 1999) art. 18, *available in* SHENZHEN TEQUBAO [SHENZHEN SPECIAL REGION NEWS], May 1, 1999.

accordance with the laws, regulations and the mortgage contract."²⁴² The Urban Mortgage Measures also contain a list of circumstances that would trigger a right to foreclose, most of which are little more than events of default that typically would be part of a mortgage.²⁴³ Although most mortgages contain a specific foreclosure right, these provisions might supply a useful tool if the instruments are not properly drawn.

Chinese statutes and regulations do not adopt the concept of acceleration directly. The statutes do, however, discuss the remedy of "rescission."²⁴⁴ In the mortgage loan context, "rescission" likely means the same thing as acceleration. When rescission occurs, the agreement that the borrower can keep the money for the set period and return it according to a set schedule is rescinded and the money is due immediately.

The Contract Law requires that if a lender desires to rescind a debt because of a default, the lender must first give advance notice.²⁴⁵ Although the subsequent article provides that the parties can agree to the terms of rescission by contract, it is unlikely that a Chinese court would view a rescission without prior notice as consistent with the civil law principles of fairness and good faith.²⁴⁶

Rescission itself is also accomplished by notice to the borrower, effective upon receipt.²⁴⁷ The Contract Law states that following rescission, but before foreclosure, the parties can provide for "overdue" interest.²⁴⁸ "Overdue" interest likely means interest at a rate higher than the original contract rate, rather than continuation of interest on the new "rescinded" debt.

²⁴² 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 36.

²⁴³ Urban Mortgage Measures, *supra* note 8, art. 40. The provisions include bankruptcy, waste, and transfer without consent. Note that Article 40 also states that foreclosure can occur as a consequence of "other situations provided for in the contract." *Id.* This suggests perhaps some latitude in the ability of the mortgagee to control the conduct of the mortgagor even in areas covered by affirmative provisions of law, such as maintenance of the property.

²⁴⁴ *See, e.g.*, Contract Law, *supra* note 27, arts. 94, 203. The Contract Law provides that after rescission, the "original status" of the parties will be restored. *Id.* art. 97. Presumably, this means the money must be repaid.

²⁴⁵ *Id.* art. 92. By providing that notice must be given prior to rescission, the Contract Law incorporates the principle of good faith.

²⁴⁶ This is due to the principle of good faith. *See supra* note 219. Without prior notice, one party may not be aware that the other party intends to rescind the contract and may still try to perform the contract. *See, e.g.*, WANG LIMING ET AL., MINFA XINLUN, II [ADVANCED STUDIES IN CIVIL LAW, VOL. II] 410-11 (1988).

²⁴⁷ Contract Law, *supra* note 27, art. 96.

²⁴⁸ *Id.* art. 207.

In China, it is possible to cure a default at any time prior to actual termination of the property interest at the foreclosure sale.²⁴⁹ It likely²⁵⁰ is also possible to provide by contract for a non-curable acceleration. The broad provisions of the Security Law authorizing private contractual arrangements are of some benefit in assuring the enforceability of such provisions.

At present, the usual practice in China is for lenders to require that borrowers maintain accounts at the lending bank. The lender has the right to set off those accounts to cover any defaults without prior notice to the borrower.²⁵¹ But it probably is necessary to provide notice to set off an amount beyond that in default.

XIV. POSSESSION AFTER DEFAULT AND THE RIGHT TO RENTS

It probably is possible for the mortgage instrument to provide for possession upon default and for a court to enforce such a right.²⁵² However,

²⁴⁹ Article 46 of the Urban Mortgage Measures states that the "disposition" of the property by the mortgagee will be stopped if the mortgagor demonstrates its ability to pay the mortgage debt. Urban Mortgage Measures, *supra* note 8, art. 46. The mortgagee must agree that the mortgagor has made an adequate demonstration, but presumably the mortgagee will have to abide by its duty of good faith and fair dealing. It is not clear whether the term "disposition" here refers to a foreclosure sale or an arrangement "in lieu of foreclosure." See *infra* Part XVI. It also is not clear whether the mortgagor must show the ability to complete performance of the debt as accelerated or just show the ability to perform the debt as originally scheduled (to "cure" the debt).

²⁵⁰ Here and at several other places in the text, the authors indicate that it is "likely" or "probable" that Chinese lawmakers will have a given interpretation of a provision of law. Because, as indicated, the statutes and regulations in question specifically provide that the parties may agree to certain terms in their contract, it would be dangerous to conclude unequivocally that it was the intent of the drafters of those statutes and regulations to authorize expansion or contraction of other aspects of the relationships regulated by the statutes and regulations. Nevertheless, a more recent statute, the new Contract Law, generally embraces the concept of freedom of contract.

The thrust of the Contract Law is freedom of contract. Article 4 states: "The parties shall have the right to enter into a contract voluntarily in accordance with the law. No unit or individual may illegally interfere." Contract Law, *supra* note 27, art. 4.

Generally speaking, where the Contract Law does address specific forms of contracts, it establishes bases for interpretation and rules to be applied in the absence of specific agreement by the parties. Most of the Contract Law's provisions can be modified or waived by specific agreement. If the parties otherwise agree in the contract, these two articles will not apply. *Id.* arts. 61-62.

Article 123 of the Contract Law, however, states that the mandatory provisions of other Chinese laws regulating specific relationships, such as mortgages, cannot be waived. *Id.* art. 123. This leaves the problem of identifying which provisions are expressly or implicitly "mandatory." Because of uncertainty in this very undeveloped area, the authors are not ready to reach definite conclusions about the enforceability of specific contract provisions relating to mortgages.

²⁵¹ Zheng Linyan, *Lun Yingmei Faxi Yinhang Dixiaoquan* [Studies on Bank Set-Off Rights in the USA and the UK] (1998) (unpublished LL.M. thesis, Peking University (China)) (on file with authors).

²⁵² The Urban Real Estate Law provides that a mortgage is an interest in which the possession of the property remains with the mortgagor during the term of the mortgage. Urban Real Estate Law, *supra* note 2, art. 46. The authors, however, believe that this language does not preclude a mortgage provision that

such a right does not exist without a provision in the mortgage.²⁵³ If the mortgagee does take possession, any leases would remain valid, since not even foreclosure of a senior mortgage terminates a lease in China. Normally, the purpose of the mortgagee taking possession is to safeguard the property against vandalism or waste (such as the removal of valuable fixtures or equipment prior to foreclosure) by the mortgagor or others. It probably also is possible for the parties to agree that the mortgagee may rent out the property, if it is not already rented, and apply any rent proceeds to the mortgage debt. If the mortgagor refuses to cooperate with such a provision, however, the mortgagee would be powerless to realize this right without a court action since the mortgagor, as the holder of the land use right, is the only party with the power to enter into valid leases.

In American commercial real estate finance law, it is possible and common for parties to assign the rents from leased commercial property to the mortgagee as security for the debt.²⁵⁴ The assignment typically does not become activated until default, and when activated the mortgagee may collect the rents and apply them to the mortgage debt prior to foreclosure. Some American jurisdictions have difficulty with these kinds of rights because of the equity of redemption concept and the lien theory of mortgages used in many American jurisdictions.²⁵⁵

In China, rents are viewed as part of the set of rights that can pass under the mortgage.²⁵⁶ Unless the parties have provided for the mortgagee to collect them, however, the mortgagor retains the right to rents until foreclosure.²⁵⁷ If the parties do create a present assignment of rents, it can be enforced by the courts.²⁵⁸ After default, however, the mortgagee has the

provides the mortgagee with interim possession of the property in the event of default. This conclusion is based in part on the fact that the later Security Law, which contains a more detailed analysis of mortgage rights, states specifically that the court may seize mortgaged property following default and, upon such seizure, use the proceeds of the property to pay the mortgage debt. This includes "natural proceeds" and "legal proceeds." "Legal proceeds" include rent. Security Law, *supra* note 8, art. 47.

²⁵³ See *supra* note 252.

²⁵⁴ See NELSON & WHITMAN, *supra* note 193, at 201-12.

²⁵⁵ See *id.*

²⁵⁶ Collecting rents is a way in which an owner can profit from the property. The right to profit from the property shall remain with the owner (mortgagor) unless otherwise provided by the contract. See, e.g., XIN ZHONGGUO MINFAXUE YANJIU ZHONGSHU [SUMMARIES AND COMMENTS ON THE CIVIL LAW STUDIES OF THE PEOPLE'S REPUBLIC OF CHINA] 397 (1990).

²⁵⁷ *Id.*

²⁵⁸ In bankruptcy, despite the fact that the rents are deemed part of the rights passing under the mortgage, the bankruptcy court will not recognize any security interest in rents already received by the mortgagor and commingled with other funds. Therefore, in situations in which it is possible that accrued rents might accumulate and become a potentially valuable asset, the mortgagee may want to require the rents to be accumulated in a separate fund which the mortgagor can access for identified purposes. These funds would thus remain separate and therefore retain their character as part of the security for the loan.

right to apply rents that accrue to the mortgagee's account.²⁵⁹ No special assignment of rents is necessary.²⁶⁰ The Security Law appears to require that the court actually order a seizure of possession following default and that the mortgagor notify the tenants to pay rent directly to the mortgagee.²⁶¹

Although the tenants apparently are obligated to pay rent to the mortgagee upon notification, China, unlike the United States,²⁶² gives leasehold tenants a broad right to offset rent.²⁶³ Consequently, if the mortgagee attempted to collect the rents without providing for performance of the mortgage covenants, it is likely that the tenants could rightfully withhold rent that corresponds to the cost of maintenance or damages accrued because of the landlord's failure to perform the lease covenants. Of course, with regard to junior leases, the mortgagee might require lessees to waive the right to offset rent. Further, a mortgagee might insist, as a condition of the mortgage, that senior lessees waive the offset right as it relates to the mortgage. Lessees do not like to give such waivers, but there may be economic circumstances in which the lessees would view it as more desirable to have the landlord set the mortgage.

Despite the theoretical entitlement to the rents upon default, however, the mortgagee has no automatic right to collect the rents simply by notifying the tenants or the mortgagor. The mortgagor is obliged to notify the tenants to pay rent to the mortgagee, and the mortgagee might have to bring a court action to compel the mortgagor to do so. This arrangement is mandated by Article 47 of the Security Law.²⁶⁴

By collecting the rents, the mortgagee assumes no obligations under the leases. Under Chinese law, however, typically the tenants can withhold

²⁵⁹ There is a puzzling provision in the Urban Mortgage Measures that appears to require that all lease proceeds accruing either before or after default be applied to the mortgage debt. See *supra* notes 222-225 and accompanying text. The authors have suggested that it is likely that this provision will not be applied to partial leases or that parties will be permitted to "contract around" the provision. If the provision applies literally, then much of the material in this paragraph is moot, as all lease revenues would be used to retire the mortgage regardless of whether there is a default.

²⁶⁰ This doctrine is a fortunate one for mortgagees, because otherwise there might be a theoretical problem with a separate assignment of rents being construed as a mortgage of a credit right, which is not a valid interest. The right to profit (including collecting rents) remains with the owner (mortgagor). *Supra* note 256.

²⁶¹ Security Law, *supra* note 8, art. 47.

²⁶² See MILTON R. FRIEDMAN, *FRIEDMAN ON LEASES* 511, 699 (5th ed. 1997).

²⁶³ Contract Law, *supra* note 27, art. 221. The Chinese tenant has a statutory right to "repair and deduct" (following reasonable notice and opportunity to the landlord to conduct a repair). *Id.* This is unusual in American common law for commercial leases and any landlord (goaded by its mortgagee) would try to negate such a right in a lease contract. Further, if problems caused by the landlord's failure to repair damage the tenant's business activities, the tenant has the option to either collect damages or extend the lease. *Id.*

²⁶⁴ Security Law, *supra* note 8, art. 47.

rent if the obligations are not performed. Further, if the property consists of residential real estate, it is likely that the mortgagee has some obligation to perform the lease obligations, at least to the extent of the rent received, due to the high priority that Chinese courts place upon residential security.²⁶⁵

XV. CAN THE PARTIES AVOID LEGALLY PRESCRIBED MORTGAGE TERMS BY CONTRACT?

A mortgage contract must be in written form. This requirement is codified in both the Security Law²⁶⁶ and the Urban Mortgage Measures.²⁶⁷ The Security Law and the Urban Mortgage Measures also list what should be contained in the contract.²⁶⁸ The form and content requirements do not prevent the parties from drafting more elaborate provisions.²⁶⁹ Considering the fact that a real estate mortgage must be registered anyway,²⁷⁰ and therefore must be written, in practice the requirement that the mortgage contain certain basic terms detracts little from the parties' freedom of contract. As described above, however, certain provisions of law that govern mortgages do inhibit the rights of mortgagors and mortgagees. Can these provisions be avoided by agreement of the parties in the mortgage contract? Currently, the answer is unclear.

The regulations that have the greatest impact on mortgage relationships are the Urban Mortgage Measures. Article 5 of the Urban Mortgage Measures indicates that the mortgage shall be entered into "in accordance with doctrines of voluntariness, mutual benefit, fairness and good faith."²⁷¹ The Urban Mortgage Measures also state that a mortgage

²⁶⁵ See Randolph & Lou, *supra* note 12, at 108-09 & n.90.

²⁶⁶ Security Law, *supra* note 8, art. 37.

²⁶⁷ Urban Mortgage Measures, *supra* note 8, art. 25; see also Urban Real Estate Law, *supra* note 2, art. 49.

²⁶⁸ Security Law, *supra* note 8, art. 39; Urban Mortgage Measures, *supra* note 8, art. 26. These requirements are somewhat obvious and basic, but are worth listing.

The Security Law requires the following items: description of the secured debt (character of the original debt obligation and the schedule of payments); description of the property (including character, size, location and identity, ownership, and the nature and identification of the land use right); and claims secured (such as penalties for late payment). Security Law, *supra* note 8, art. 39.

The Urban Mortgage Measures contain far more elaborate requirements. In addition to the items required by the Security Law, the Urban Mortgage Measures require the contract to include the identity of the parties, the value of the property, the duties of maintenance of the property, and any conditions that might trigger the release of the mortgage (presumably other than full payment); liability terms, such as contract penalties, for parties who breach the mortgage agreement; provisions for dispute resolution; and the time and place of signing. Urban Mortgage Measures, *supra* note 8, art. 26.

²⁶⁹ Security Law, *supra* note 8, art. 39.

²⁷⁰ See *supra* Part VIII.

²⁷¹ Urban Mortgage Measures, *supra* note 8, art. 5.

created in accordance with the law "will be protected by the state."²⁷² Together, these regulations imply that any mortgage that departs from the standards of the Urban Mortgage Measures will not be protected by the state because, in the broadest sense, the Urban Mortgage Measures themselves can be interpreted as the law. This implication must be balanced against the general policy in favor of freedom of contract.²⁷³

In addition, the 1990 Regulations on Granting Land Use Rights provide that no mortgages may "conflict with the provisions of state legislation or the contract for the grant of the land use right/leasehold."²⁷⁴ This provision, though still in effect, has become relatively antiquated as a result of the fast-paced development of Chinese property regulation and may not add much to the language in the Urban Mortgage Measures. The provision was adopted by the State Council, however. The State Council is a higher entity than a ministry. Thus, the provision cannot be regarded as helpful to those wishing to argue in favor of freedom of contract in this area.

The Security Law affirmatively provides that the parties cannot contract in the mortgage agreement to transfer a deed in lieu of foreclosure,²⁷⁵ although they may do so after default.²⁷⁶ The presence of this affirmative injunction against the contractual modification of certain legal rights suggests that the drafters of the Security Law intended to allow the parties to contract out of other provisions of the Security Law unless they are expressly prohibited from doing so.

The Urban Mortgage Measures contain language indicating that a mortgagee may initiate a foreclosure on the basis of any of a series of listed events or any "other circumstances as stipulated in the mortgage contract."²⁷⁷ This language suggests that there is room for the parties to negotiate provisions limiting the behavior of the mortgagor in circumstances other than those specifically listed in the law. Nevertheless, it remains unclear whether contract language can depart from the provisions of existing laws.

²⁷² *Id.*

²⁷³ The concept of freedom of contract was not set forth explicitly in the General Principles of the Civil Law or the Economic Contract Law. Instead, scholars read the doctrine of freedom of contract into Article 4 of the General Principles of the Civil Law, which establishes the doctrine of voluntariness. See, e.g., XIN ZHONGGUO MINFAXUE YANJIU ZHONGSHU, *supra* note 256, at 46-48, 417. The new Contract Law addresses the issue directly, however. According to Article 4, "The parties shall have the right to enter into a contract voluntarily in accordance with the law. No unit or individual may illegally interfere." Contract Law, *supra* note 27, art. 4.

²⁷⁴ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 34.

²⁷⁵ Security Law, *supra* note 8, art. 40.

²⁷⁶ *Id.* art. 53.

²⁷⁷ Urban Mortgage Measures, *supra* note 8, art. 40.

Lenders and borrowers, of course, will want to shape the mortgage relationship to suit themselves. The lender will want to strengthen provisions dealing with the borrower's duties to maintain the property.²⁷⁸ The borrower will want to avoid the statutory limits on transfer and leasing, including the requirement that all revenues from such activities be applied as a prepayment on the mortgage.²⁷⁹

Chinese lawmakers²⁸⁰ may conclude that although a borrower's rights under mortgage laws and regulations cannot be limited by contract beyond the provisions of the mortgage laws, it is possible for the parties to agree to alter the lender's rights. This approach would reflect the traditional imbalance in the mortgage relationship. In the United States, the legal system reflects the view that mortgage law is necessary to limit overreaching by the lender. American courts might give the borrower the ability to bargain for waivers of the mortgagee's rights but refuse to uphold waivers of the borrower's rights. At present, however, there is no equivalent concept in the very young jurisprudence of modern Chinese mortgage law, and Chinese statutes and regulations, as indicated, favor the mortgagor's position.

Despite the provisions described above, the authors conclude that, as a practical matter, Chinese lawmakers will have to recognize at least the validity of clear mortgage provisions that give the mortgagor the right to generate income without paying it directly to the mortgagee. The inconsistency created by prevailing commercial real estate practices compels such a practical accommodation. It is more difficult to say whether Chinese lawmakers will also recognize such departures from the legal provisions related to property maintenance.

XVI. FORECLOSURE

Article 53 of the Security Law provides that when the debtor fails to perform its duty when it is due, the mortgagee may consult with the mortgagor to take possession of the property or to sell the property by auction.²⁸¹ If the parties cannot reach an agreement, then the mortgagor

²⁷⁸ Articles 36 and 39 of the Urban Mortgage Measures provide for the maintenance of the property with regard to a real estate mortgage. These provisions do not require the mortgagor to restore the devalued property where the devaluation is not a result of the mortgagor's fault. *Id.* arts. 36, 39.

²⁷⁹ *Id.* art. 37.

²⁸⁰ Note that the reference to "Chinese lawmakers" here is not necessarily to the courts. When government regulations require interpretation, it is quite common for the courts to ask the relevant state agency for guidance. Therefore, the very agency that sets forth a regulation also may be called upon to decide whether that regulation can be varied by contract.

²⁸¹ Security Law, *supra* note 8, art. 53.

should bring the case to court. The balance of this section addresses what happens when the parties fail to reach an agreement.

A. *Judicial Actions*

1. *Venue*

Foreclosure actions generally should be brought to the people's court with jurisdiction over the area in which the property is located.²⁸² This is different than the rule for foreclosure of movable property. Such foreclosures should occur in the domicile court for the area in which the mortgagor is located.²⁸³ Usually the case is heard in the basic people's court.²⁸⁴ A major case involving a foreign element or a case which may have a major impact on the area in question, however, will be heard by the Intermediate People's Court of the place where the real estate is located.²⁸⁵ In exceptional circumstances, the case may be brought to the High People's Court²⁸⁶ or the Supreme People's Court.²⁸⁷ Usually the court only decides whether the mortgagee has the right to foreclose. If the mortgagor (or the debtor, if they are not the same person) denies the existence of the debt, however, and this issue has not been resolved in an earlier action on the debt, the court must also decide whether the mortgagee has a credit right for payment of the debt.²⁸⁸

If the court immediately orders foreclosure, it can issue a judgment establishing the mortgagee's right to foreclose.²⁸⁹ The mortgagee may apply to the court for execution of the judgment.²⁹⁰ Usually, the court that delivers the judgment is the same court that executes the judgment. If, however, the

²⁸² China's Civil Procedure Law provides that a lawsuit related to a dispute over real estate shall be under the jurisdiction of the people's court of the place where the real estate is located. Zhonghua Renmin Gongheguo Minshi Susongfa [Civil Procedure Law of the People's Republic of China] (adopted Apr. 9, 1991) [hereinafter Civil Procedure Law] art. 34, *translated in* LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1990-1992 185-240 (1993).

²⁸³ *Id.* art. 22.

²⁸⁴ *Id.* art. 18.

²⁸⁵ *Id.* art. 19.

²⁸⁶ The High People's Court has jurisdiction if the case has major impact on the area under that court's jurisdiction. *Id.* art. 20.

²⁸⁷ The Supreme People's Court has jurisdiction if the case has major impact on the whole country, or if for some other reason the Supreme People's Court concludes that it should try the case as the court of first instance. *Id.* art. 21.

²⁸⁸ The mortgagor, as defendant, has the right to admit or rebut the claims and has the right to file counterclaims. *Id.* art. 52.

²⁸⁹ If the mortgagor counterclaims to deny the mortgagee's credit right, however, the judgment must first establish the mortgagee's credit right.

²⁹⁰ Civil Procedure Law, *supra* note 282, art. 216.

judgment is made by a High People's Court or the Supreme People's Court, then the judgment will be executed by the Intermediate People's Court or the county court of the place where the property is located.²⁹¹ If the case is not tried by the court in the place where the property is located, the court that issues the judgment must request that the court in the place where the property is located execute the judgment.²⁹²

Often the mortgagee will not seek an immediate foreclosure order, but rather will request a court order directing the debtor to pay the debt within a set period of time. If the debtor fails to do so within the time stipulated in the judgment, the mortgagee may return to the court to ask for the court's assistance in reaching assets of the debtor. These assets may include other assets in addition to the mortgaged property. The foreclosure of the mortgage is only one action that the mortgagee may request.²⁹³

2. *Timing*

Under the Civil Procedure Law, foreclosure suits are not supposed to take longer than six months in normal circumstances.²⁹⁴ There is insufficient evidence from which to judge the seriousness of these deadlines. Discussions with attorneys who practice in China suggest that local courts still are quite protective of local interests and are slow to perform their responsibilities when they must help an "out of town" creditor collect a debt from a local debtor. It would be unusual for the court actually to refuse to grant judgment in favor of the creditor when the circumstances warrant such a judgment. However, execution of the judgment might be painfully slow and may give the debtor ample opportunity to "strip" the property or to minimize the impact of the foreclosure in some other fashion.

3. *Election of Remedies*

In America, mortgagees often choose between filing for a general judgment (a "suit on the note") and foreclosing a mortgage. The

²⁹¹ *Id.* art. 209.

²⁹² *Id.* art. 210.

²⁹³ The Commercial Banking Law prohibits commercial banks from investing in real estate unless the investment is for their own use. Commercial Bank Law, *supra* note 44, art. 43. Article 42, however, permits banks to acquire property at foreclosure and hold it for one year prior to disposition. *Id.* art. 42. Through various administrative processes, it is likely that Chinese banks could effectively extend this holding period in appropriate cases, but there nevertheless is some restriction on the ability of Chinese banks to hold foreclosure property indefinitely.

²⁹⁴ Civil Procedure Law, *supra* note 282, art. 135.

mortgagee's choice may have an impact on its right to make a priority claim against the mortgaged property. If an American lender pursues a general judgment against a creditor, the priority of that judgment, even if it began as a secured claim, will generally date from the filing of the judgment. In China, the choice between the suit on the debt and the foreclosure of the mortgage is irrelevant, since a general judgment gives the secured creditor basically the same priority rights against the mortgaged property as a mortgagee filing for foreclosure.²⁹⁵ If a creditor has a general unsecured claim against a debtor and seeks a judgment, the judgment creditor has the same right as a mortgagee to have the property sold, and all of the mortgages are satisfied from the sale in order of priority.²⁹⁶ If the creditor is a mortgage creditor, then the priority of that creditor's mortgage, as well as that of others, will be recognized in the sale to collect on the general judgment.

4. Notice

American due process and procedural rules mandate that all subordinate parties whose interests will be foreclosed by judicial decision must be notified of the foreclosure proceeding in advance.²⁹⁷ There is no such rule in China. Judgment lien holders in China likely have little protectable interest in a foreclosure proceeding. Such lienholders are junior to all mortgages, regardless of the date of attachment of the judgment,²⁹⁸ and they likely have no right to participate in the proceeds of the sale. Their only recourse is to seek to attach any foreclosure surplus in the hands of the mortgagor.²⁹⁹ It is possible that they would have some basis for contesting the validity of a mortgage foreclosure that threatens to destroy their interest in the property,³⁰⁰ but this right, if it exists at all, likely does not include a

²⁹⁵ As discussed above, even if the creditor initiates a foreclosure action, the court may still issue a general judgment. See *supra* Part XVI.A.1. In addition, it is generally accepted that a court's judgment is only a confirmation of the civil rights of the parties and cannot create new rights for the parties. See, e.g., LIU JIAXING, *MINSHI SUSONGFA JIAOCHENG* [CIVIL PROCEDURE LAW TEXTBOOK] 70-84 (1982).

²⁹⁶ *Id.*

²⁹⁷ See NELSON & WHITMAN, *supra* note 193, at 492-97.

²⁹⁸ This is because a judgment lien right is not a right *in rem*. Therefore, it attaches only to those things that the judgment debtor owns at the time the attachment is sought. The judgment debtor does not own that element of the property that is subject to a mortgage.

²⁹⁹ WANG LIMING, *supra* note 62, at 692.

³⁰⁰ The authors infer the existence of such a right from the Contract Law, which provides generally that if an obligor fails to protect a credit right that is due to the obligor, an obligee may be subrogated to the obligor's rights. Contract Law, *supra* note 27, arts. 73-74. The Civil Procedure Law provides that if a third party has an interest that will be affected by a proceeding involving two other parties, the third party may join in the proceeding and the court has discretion to notify the third party of that opportunity. Civil Procedure Law, *supra* note 282, art. 56.

right to formal notice of the proceeding. Consequently, such lienholders must watch the legal publications in order to obtain notice of foreclosure.

Mortgagees junior to the foreclosing mortgagees are paid out of the foreclosure sale proceeds³⁰¹ and likely will be contacted by the court, which can identify them through the registration records. Again, however, it is unlikely that junior mortgagees have a right to formal notice, which would alert them to the opportunity to contest the foreclosure before the foreclosure action takes place. They may or may not have such a right to contest the foreclosure, but that right, if it exists, likely does not include a right to formal notice.

As a practical matter, if not a matter of legal necessity, it is wise to notify the holders of senior mortgages on the property that the foreclosure of a junior mortgage is occurring. The court may also notify these parties, but if there is an error in notification and consequently an error in paying them their claims from the foreclosure proceeds, this conceivably could cause a problem for a junior foreclosing mortgagee.

Further, it would be wise to notify any senior or junior lessees of the foreclosure. Lessees have a pre-emptive purchase right, which arguably could interfere with the rights of a purchaser at a foreclosure sale, regardless of whether the mortgage is senior or junior to the lease.³⁰² The authors believe, however, that the pre-emptive right is satisfied if the lessee is notified of the foreclosure sale and given an opportunity to bid at the auction. Thus, foreclosing mortgagees would be wise to ensure that notice of the sale is provided.

³⁰¹ See discussion *infra* notes 306-313 and accompanying text.

³⁰² The civil law recognizes a "refusal right," which is a right of first refusal in a tenant as to both the resale and reletting of leased property. Contract Law, *supra* note 27, art. 230. Opinions on the General Principles of Civil Law, *supra* note 37, art. 118. The refusal right need not be set forth in the lease agreement. The civil law might regard a lease contract that excludes such a right as inherently unfair. The Supreme People's Court commentary recognizing this right does not differentiate between commercial and residential leases, so we must assume that it applies to both, although it is possible that subsequent interpretations may narrow its application. The right probably inheres both in leases of buildings as well as in leases of land use rights. See Chengshi Shiyou Fangwu Guanli Tiaoli [Regulations on the Administration of Urban Privately Owned Buildings] (issued Dec. 7, 1983) art. 11, available in ZHONGHUA RENMIN GONGHEGUO FANGDICHAN ZHENGCE FAGUI DAQUAN [A COMPLETE COLLECTION OF REAL ESTATE POLICIES AND LAWS OF THE PEOPLE'S REPUBLIC OF CHINA] 128-131 (Huang Xuhai et al. eds., 1993).

B. *Conduct of Auction*

Mortgages are foreclosed by auction.³⁰³ In the past, a court normally would conduct the foreclosure auction. Under the Auction Law,³⁰⁴ this procedure is entrusted to licensed auction specialists.

There is no clear rule on whether the mortgagee is required to sell land in parcels to reduce the impact of the foreclosure on the mortgagor. The Urban Mortgage Measures provide that, unless the mortgage contract states differently, multiple parcels will be treated as one parcel.³⁰⁵ But the general predisposition of the Chinese courts to equitable treatment of borrowers may lead a court to enter a foreclosure order compelling sale in parcels where warranted.

C. *Distribution of Proceeds*

The Urban Mortgage Measures provide for the order of disposition of sale proceeds.³⁰⁶ Following payment of the costs of sale, the first proceeds are used to pay accrued taxes. Thereafter, the first priority mortgage will be satisfied. Unlike American mortgages, Chinese mortgages, if foreclosed in court, typically are foreclosed together with all other mortgages on the property so that priority may be realized through an order of distribution.³⁰⁷ If secured claims against the property are reduced to a judgment, the court may distribute the proceeds to the parties promptly.³⁰⁸ The court may recognize claims not yet due or not reduced to judgment by setting aside a portion of the proceeds, and the mortgage security can be transferred from the real estate to that fund.³⁰⁹ Each claimant first receives payment of any

³⁰³ It appears that the auction process is mandatory. The Urban Real Estate Law expressly defines a mortgage as an instrument under which property will be sold at auction upon default. Urban Real Estate Law, *supra* note 2, art. 46.

³⁰⁴ Auction Law, *supra* note 49, art. 9.

³⁰⁵ Urban Mortgage Measures, *supra* note 8, art. 10.

³⁰⁶ *Id.* art. 47.

³⁰⁷ The 1990 Regulations on Granting Land Use Rights acknowledge the priority claim of the senior mortgagee in the proceeds of a foreclosure sale. 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 37.

³⁰⁸ If there is no dispute over the secured claims, however, it is not necessary to reduce them to a judgment.

³⁰⁹ This would appear to place junior creditors at some disadvantage, since senior claims that are unadjudicated and not yet due may block access to the mortgage proceeds, even though ultimately it could be argued that junior creditors do not need to access those proceeds in order to satisfy their claims. But if a junior creditor is faced with this situation (proceeds that it wishes to reach are locked up in court and the junior creditor has no other resort to any of the debtor's assets), the creditor may initiate a bankruptcy proceeding. In the bankruptcy proceeding, all of the debtor's debts are accelerated, and the senior debt is

contractual debt. The claimants then receive damages for any breach of the mortgage obligations not covered by a contract penalty or the principle and interest obligations.³¹⁰ Only after the highest priority mortgagee has been satisfied as to all of these claims may payment be made to the next interest in priority.

The authors have not found any authority that provides for payment to judgment lien holders other than mortgage holders. They believe that such claimants have no right to participate in a foreclosure proceeding. Judgment lien holders should seek satisfaction from any surplus proceeds from the foreclosure sale.

As noted above, it is possible that some of the improvements to a mortgaged property will not be part of the mortgage, as they will have accrued after the mortgage was registered. Such improvements can be sold with the foreclosed property, but the court may segregate the proceeds of the sale that can be allocated to these improvements and distribute them to the mortgagor or other parties entitled specifically to the proceeds.³¹¹ If the mortgagee has a general judgment and there is a deficiency after it has received its higher-priority proceeds distribution, it can participate in the distribution of these other non-priority proceeds pro rata with other judgment holders.³¹²

When the security consists of an allocated land use right, the proceeds of the sale are first be used to pay the fees necessary to accomplish the conversion of that right to a granted land use right.³¹³ Only then may the proceeds be paid to the mortgage holder and other parties with an interest in the property.

D. *Settlements in Lieu of Foreclosure*

The Security Law allows lenders to reach individual agreements with borrowers for non-judicial transfers of mortgaged property upon default of the debtor. The agreement can be reached at the time of default,³¹⁴ but it

liquidated. This may or may not result in proceeds becoming available to the junior creditor, but at least the uncertainty will be resolved.

³¹⁰ In the experience of the authors, damage claims are rarely appropriate when the debt has been satisfied and any additional penalties have been paid. Most of the provisions of the typical mortgage are there to ensure the payment of the debt itself, and repayment of the debt constitutes complete satisfaction of these obligations.

³¹¹ See, e.g., Security Law, *supra* note 8, art. 55.

³¹² *Id.* art. 47.

³¹³ *Id.* art. 56.

³¹⁴ *Id.* art. 53.

cannot be negotiated as part of the original lending agreement.³¹⁵ Under American law, an agreement to transfer the property in lieu of foreclosure contained in the original instrument is void as a "clog on the equity of redemption."³¹⁶ Chinese law appears to correspond to the American law in this respect. In China, a transfer in lieu of foreclosure will not cut off the rights of junior lessees.³¹⁷ There is no clear law, however, that specifies the impact of a transfer in lieu of foreclosure on the rights of other holders of junior interests. One could argue in theory that the consent of a senior mortgagee to the creation of a junior interest is implicitly a consent to the continued effect of the junior interest following a transfer in lieu of foreclosure. American practice, however, recognizes a distinction between approving a junior interest attaching to the mortgagor's title prior to foreclosure and approving such an interest after foreclosure. Chinese law appears to make the private transfer equivalent to foreclosure for many purposes. There certainly is an argument that the mortgagee's consent to the junior interest is not a waiver of the mortgagee's right to claim that the transfer in lieu of foreclosure eliminates the junior interest.

When the original senior mortgage instrument provides for transfer in lieu of foreclosure, no party should take a junior encumbrance or other interest without ascertaining what its status would be in the event of a transfer in lieu of foreclosure to a senior mortgagee.³¹⁸ When the mortgage makes no provision for this type of transfer, the same practice should be followed, but it is unlikely that junior parties will focus on private transfers in lieu of foreclosure that might eliminate their rights.

Quite possibly, a Chinese court could rule that when there is clear value in the property in excess of the senior mortgage amount, the junior party has a right to compensation from the senior mortgagee for loss of the interest. Another possibility is that the courts could conclude that junior interests survive such private transfers to the mortgagee unless the mortgage provides for a different result. The authors believe that this is a useful interpretation of the Security Law. Junior parties would have little security in making investments in property subject to a mortgage if the mortgagee and mortgagor could later agree to eliminate the junior interests. It is far

³¹⁵ *Id.* art. 40.

³¹⁶ See generally NELSON & WHITMAN, *supra* note 193, at 32-38.

³¹⁷ See Urban Real Estate Law, *supra* note 2, art. 11; see also Contract Law, *supra* note 27, art. 229.

³¹⁸ Although Chinese registration records, unlike American land records, do not contain the contents of the senior mortgage document, they indicate the existence of this document. A cautious junior interest holder can demand the right to inspect any senior security instruments and consequently it is unlikely that a Chinese court would view the consequences of carrying out the provisions of such senior instruments as unfair to a junior party.

better to require the senior mortgagee to make clear arrangements in the mortgage if it wants the right to cut off junior interests without foreclosure.

E. Rights and Duties of Foreclosure Sale Purchasers

Parties that acquire property at mortgage foreclosures have an affirmative duty to register their ownership of both land and buildings.³¹⁹ Mortgagees and other foreclosure purchasers should keep in mind that a property interest sold at foreclosure confers only a right to continue the existing use of the land.³²⁰ If this use has proven to be unprofitable (and this is a distinct possibility in light of the default by the borrower), the land use right may have a significantly lower value than it originally had. It should be noted, however, that the use restrictions on granted land use rights are in most cases no more specific than zoning designations under land use planning regimes in the West, so the risk that the approved use will not be economical is in most circumstances no different than the risk that Western mortgagees face today.

Purchasers at foreclosure sales face a special problem in China's "anti-speculation" policies, which are designed to ensure that parties that hold land use rights are indeed putting the property to productive use. Under the Urban Real Estate Law, holders of land use rights face forfeiture of their rights if they fail to use the property as stipulated within two years.³²¹ Chinese law does not address the issue of whether foreclosing mortgagees (or others who purchase at foreclosure sales) should be permitted special latitude in holding property undeveloped following foreclosure. It is likely that no special consideration will be given to the mortgagee beyond a brief time to complete the project upon obtaining the right of possession.

Chinese lawmakers, however, should give some consideration to providing latitude to lenders who wish to convert land use rights upon foreclosure. There is not much experience with such practices, but the

³¹⁹ 1990 Regulations on Granting Land Use Rights, *supra* note 2, art. 36.

³²⁰ The mortgagee does have the right to change the use of the land. Approval from the authorities must be obtained before the use may be changed, however. If the new use is considered more valuable than the former one, extra payment for the new use may be required. Urban Real Estate Law, *supra* note 2, art. 17.

³²¹ *Id.* art. 25. It should be noted that the law is even more severe for parties that fail to initiate the identified use within the time periods provided for in the land use contract. Failure to initiate the identified use within even one year can result in a fine of up to 20% of the amount paid for the right, and failure to initiate the use within two years can lead to forfeiture of the property. These provisions also affect mortgagees, since defaults often occur in the early stages of a project. It is likely that development activities will stop during a foreclosure process.

matter could be resolved by acknowledging that the property under a present use restriction is less valuable than before and that therefore (assuming that the changed use is consistent with local land use planning policies), there should be no additional fee paid for the conversion, other than administrative expenses.

XVII. RIGHTS OF JUNIOR PARTIES

It is possible to have junior mortgages, but the Security Law prohibits mortgaging the property for an amount greater than its value.³²² A borrower who registers a senior mortgage has a duty to inform subsequent mortgagees of such prior mortgages.³²³ Theoretically, it is possible for junior mortgagees to search the records for the registration of prior mortgages. In any event, the junior mortgagee is subject to the rights of a registered senior interest regardless of whether the junior mortgagee has actual knowledge of the senior mortgage.³²⁴ If the junior mortgagee forecloses, the property is liquidated and the first proceeds are paid to the senior mortgagee.³²⁵

If the senior mortgagee forecloses and the junior mortgagee does not have a judgment, it is likely that the junior would join the foreclosure action. In such cases, the junior mortgagee would ask the court to find that the junior mortgagee's debt is due and that the junior mortgagee is entitled to a general judgment. With that judgment, the junior mortgagee would be able to participate in the distribution of the proceeds of the senior's foreclosure sale, if it occurs.³²⁶ If the junior for some reason cannot obtain a judgment at the same time as the senior mortgagee, the junior mortgagee could petition the court to set aside funds with a third party for distribution to the junior mortgagee when its debt claim is finally adjudicated.³²⁷

The danger that a junior interest will be lost if not brought to judgment at the time of a senior foreclosure underscores the significance of having cross-default provisions in any junior mortgage. The junior mortgagee still has the problem of monitoring the senior mortgage relationship, however. Theoretically, a mortgagee has a right to monitor the

³²² Security Law, *supra* note 8, art. 35; *see also* Urban Mortgage Measures, *supra* note 8, art. 9.

³²³ Urban Mortgage Measures, *supra* note 8, art. 9.

³²⁴ Registration provides constructive notice of the mortgagee's right. Because the registration records for mortgages are available for public inspection, a reasonably cautious junior mortgagee should perform an inspection. Security Law, *supra* note 8, art. 45.

³²⁵ *Id.* art. 54.

³²⁶ The Security Law provides for the distribution of sale proceeds to claimants in the order of registration. *Id.*

³²⁷ *See supra* notes 308-309 and accompanying text.

affairs of the debtor and to require reports concerning the debtor's economic status.³²⁸ The best protection, however, is clear communication with the senior mortgagee itself, perhaps backed up by some measures to convince the senior mortgagee that its best economic interests will be served by cooperating with the junior mortgagee.

The impact of the Security Law on the rights of junior mortgagees when senior lenders have created special default rights by contract is uncertain. It is probable that a junior mortgagee in this situation would go to court to seek an evaluation of the property in question to determine whether there is surplus value above the amount of the senior mortgagee's claim. If the evaluation reveals such a surplus, the court could order the senior mortgagee to pay the surplus amount in court as a condition of the transfer of the property to it. A junior mortgagee's mortgage attaches to such funds. If the senior mortgagee resists this plan, it is likely that the court would order an auction of the property to resolve the value issues.³²⁹

Other parties with interests junior to a mortgage, except for the mortgagor's lessees, have no rights in the foreclosure proceeding and must take their chances.³³⁰ The mortgagor has a duty to inform these parties of the existence of mortgages at the time the mortgagor transfers the interest to them.³³¹ However, if the mortgagor does not make this disclosure, the traditional recourse is an action for damages against the mortgagor, who in most cases will be in financial ruin by the time the problem is disclosed.

Junior lessees enjoy a special status. The Contract Law provides that a transfer of property subject to a lease does not terminate the lease.³³² Although this provision does not apply directly to mortgage foreclosures, a mortgage foreclosure involves a transfer to the foreclosure purchaser of the land use right that is the subject of the mortgage. Therefore, there is every reason to believe that the Contract Law applies in this situation.³³³

³²⁸ See Contract Law, *supra* note 27, art. 202.

³²⁹ It is now a common practice in China for courts to determine the value of the property through auctions. So, if there is a dispute between a senior and junior mortgagee over the value of the property, the court will likely turn to an auction to resolve the disputes.

³³⁰ As the discussion in the ensuing paragraph indicates, there are provisions of law protecting junior lessees from termination upon foreclosure. It might be possible to make an argument in favor of protecting other junior interests, but the statutory provisions in question are specific in their reference to leases. As such, we have concluded that it would not be safe to suggest that junior interests other than leases are protected.

³³¹ Security Law, *supra* note 8, art. 49.

³³² Contract Law, *supra* note 27, art. 229.

³³³ This appears to be the consensus of commentators on the provision. See, e.g., WANG LIMING, *supra* note 62, at 701-713.

XVIII. SUBROGATION

Under American law, parties other than the mortgagor that have an interest in a mortgage loan, such as sureties and holders of junior interests, have the right to pay off a senior debt in default and to be subrogated to the position of the creditor.³³⁴ Generally speaking, however, the party owed a credit right in China is entitled to receive performance from the obligor.³³⁵ It is possible, however, that the doctrine of good faith requires a mortgage creditor to accept payment from a junior party that wants to protect its own interest.

Whether such payment would result in subrogation (a court-enforced vesting of the mortgagee's security interest in the party paying the debt) is another matter. The Contract Law now recognizes the concept of subrogation in the debtor/creditor context, but the relevant sections of the law only deal with subrogation to collect a contract right owed to a debtor when the debtor fails to pursue that right.³³⁶ This form of subrogation is distinct from that used to protect junior parties in American law. Further, the complexities of recognizing implied assignments of credit rights may lead the courts to depart from the American subrogation model.

The parties could provide for the purchase and the assignment of a mortgage loan from a creditor to another party who takes the assignment at the behest of the borrower. The creditors would have to agree to such an arrangement, however.

XIX. DEFICIENCY CLAIMS

A mortgagee may sue on a note without foreclosing, obtain a general judgment, and collect that judgment against other property of the mortgagor.³³⁷ All of this can be done without waiving the priority right under the mortgage. In fact, as discussed above, it appears that the common practice in China is for mortgagees to complete a suit on the obligation first, obtain a general judgment, and then proceed to foreclosure only if the circumstances warrant.³³⁸ There is no "one form of action" concept in China's Civil Procedure Law. If the mortgagee does foreclose, a court may

³³⁴ RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES), *supra* note 178, §6.4.

³³⁵ See WANG LIMING, *supra* note 74.

³³⁶ Contract Law, *supra* note 27, arts. 73-74.

³³⁷ *Supra* Part XVI.A.3.

³³⁸ See *supra* Part XVI.A.

in the same action enter a judgment for the surplus debt that remains unpaid following the foreclosure.³³⁹

There is no express limitation on deficiencies. Such limitations are part of the mortgage laws in many American states. The principle of fairness expressed in the General Principles of the Civil Law, however, may place a limit on the ability of a lender to collect a deficiency when the price obtained from a foreclosure sale is for some reason not a true reflection of the market value of the security. The deficiency claim and the general judgment, of course, are credit rights under the Chinese system of legal rights.

XX. SUMMARY AND CONCLUSIONS

China's most recent statutes and regulations dealing with mortgages have addressed most of the important issues concerning the structure of a modern commercial mortgage. It can no longer be said that Chinese real estate law is a "void" with respect to such issues. In a number of respects, Chinese legislators are to be complimented for the thoroughness and thoughtfulness of their work on a market system so alien to their traditions. Three major problems with mortgage law in China remain, however: (1) too great a preference for lenders, (2) too great a preference for lessees, and (3) "mechanics" or uncertain policies that seem at odds with the overall goal of a working financial marketplace. These problems are summarized below. In addition, as noted elsewhere in the text, the authors recommend that China adopt interpretive policies which permit clarity, flexibility, and true enforceability for commercial mortgage agreements.

A. *Problems Resulting From Overfavoring Lenders*

Chinese mortgage lenders are largely state-supported banks,³⁴⁰ and the traditional socialist preference to give the government all the cards is evident

³³⁹ The Security Law provides that there is an indebtedness for any deficiency remaining after distribution of foreclosure proceeds to pay off existing secured debts. Security Law, *supra* note 8, art. 53.

³⁴⁰ Although the authors do not have precise statistics on mortgage lending by state commercial banks, the domination of the state commercial banks is obvious. The profits of the "big four" (the Industrial and Commercial Bank of China, the China Construction Bank, the Agricultural Bank of China, and the Bank of China) accounted for 50% of the profits in China's banking system in 1998. These banks hold 68% of the nation's deposits, 77% of all loans, 75% of the country's total assets, and employ 66% of those who work in the banking sector. These percentages were calculated by the authors based on statistics provided in China Financial Outlook. See ZHONGGUO JINRONG ZHANWANG [CHINA FINANCIAL OUTLOOK], 81, 82-86 (1999).

in certain provisions of China's mortgage law. In a number of circumstances, the laws give the mortgagees more benefits than they need. The most important example is the provision that gives lenders control over the resale of mortgaged property even when the lender is to be repaid fully from the proceeds of the resale. Although it might be said that the lender routinely will approve such proposed sales, allowance must be made for bureaucratic delay and ineptitude.

In the modern world of sophisticated real estate transactions, delay can kill a transaction, especially when the delay is caused by uncertainty related to the enforceability of the transaction agreement. The authors urge Chinese lawmakers to read the mortgage laws to permit the resale of the property without the prior consent of the lender when the mortgage is to be wholly paid as a result of the sale. The mortgagee suffers no harm from such a rule. Furthermore, under the present law, the sale proceeds must be applied to the mortgage debt, so it is not necessary for the law to require that such language appear in the sale agreement before the agreement can be enforced.

The authors also believe that the requirement for mortgagee approval should be eliminated entirely, even for situations in which the proceeds would not be adequate to retire the mortgage. The mortgagee can protect itself by inserting a due-on-sale clause into the mortgage, which would give the mortgagee the right to call in the loan if the property were transferred. This provision is an adequate deterrent against transfers. Assuming that land registration records are available for the mortgagee's inspection, landowners know that if they transfer property without the mortgagee's consent, they will face serious and immediate economic consequences. In most cases, this threat is sufficient to prevent resale without prior arrangements with the mortgagee in most cases, just as it is in most commercial settings in America.³⁴¹ To go further and permit the mortgagee to invalidate the sale or pose a threat of doing so unnecessarily dampens the marketing of mortgaged properties. Open markets are stronger markets and produce more secure values in property. This ultimately benefits lenders as well as borrowers.

The authors also urge the repeal of the language in Article 37 of the Urban Mortgage Measures that requires the application of the proceeds of leasing and sale transactions to the mortgage debt. Again, mortgagees should be free to bargain for such provisions, but to make such an

³⁴¹ It must be admitted that in some circumstances, particularly in some housing markets, homeowners do try to avoid the due-on-sale clause by hiding evidence of the sale. But China's rigid registration requirements should give the mortgagee greater power to prevent such deception than an American mortgagee would have.

application of proceeds mandatory in every mortgage loan unnecessarily impedes the ability of both mortgagee and mortgagor to create a sensible balance of economic controls over the investment. Borrowers take out loans because, presumably, they have the will and the ability to use the borrowed funds to make intelligent and profitable business decisions. The mortgagee is not in the property management and development business—it is in the lending business. Mandatory provisions that hamper the parties' ability to provide flexibility to the borrower to work out the borrower's business plans are impediments to a successful real estate market.

B. Problems Resulting from Overfavoring Lessees

In one important area—the relationship between a mortgagee and a lessee of the same land—two significant value structures conflict. Chinese lawmakers favor mortgagees, but they also favor tenants. This conflict leads to a somewhat uncomfortable set of compromises that can interfere with the flexibility of mortgage financing. In the long run, the lack of a free marketplace for mortgage money will work to the disadvantage of lenders, borrowers, and lessees.

One example of the conflict is the treatment of leases at foreclosure. Chinese law appears to protect junior lessees from the impact of mortgage foreclosure. Under the American default rule, however, junior lessees are destroyed when a senior mortgagee forecloses. The difference in treatment may catch American practitioners by surprise, but does not necessarily point to a flaw in the Chinese system.

In America, the default rule concerning lease priority is subject to adjustment when the economic interests of the parties make such adjustment necessary. This is usually the case when a mortgagee lends on property that the parties anticipate will be leased to high-credit tenants. Either at the time of mortgage or at the time of later leasing, the mortgagee can agree to a “non-disturbance” clause to protect the interests of powerful lessees that are attractive to the mortgagee. Such clauses add value to the project. American mortgagees, however, generally reserve judgment as to less significant lessees. Well-crafted mortgage arrangements usually give the lender the option to retain the lessee or dispose of the lessee at the time of foreclosure. This is true even with regard to lessees that predate the mortgage itself, since lenders usually require that lessees subordinate their interest to the mortgage. Anticipating this requirement, landlords

themselves require the lessee's consent to subordinate as a condition of the lease.

It is unclear whether Chinese law permits the creation of mortgage provisions that will affect the priority of leases entered into after the mortgage. There is no particular value in Chinese law that precludes such an arrangement, but the authors have identified nothing in the law that would expressly permit it either. The authors hope that Chinese legal authorities will clarify whether such bargains are possible in China.

Another market impediment is the current ambiguity as to how the tenant's pre-emptive right to purchase may impact the mortgage relationship. The authors have speculated that this right will be viewed as satisfied when the lessee is given the power to participate in a foreclosure sale. But the potential right of the tenant to exercise its pre-emptive right might preclude negotiations between a mortgagee and mortgagor trying to resolve a difficult debt situation in lieu of foreclosure.

A more difficult issue arises with regard to the impact of the tenant's pre-emptive right on negotiations for settlement of a default without foreclosure. Here there is no formal process to dispose of the tenant's right. Thus, the tenant becomes a third party at a bargaining table that already carries a weighty agenda. Negotiations to resolve defaults informally are commonplace in every viable financial system and there is no reason why lessees should have guaranteed rights that could prevent a mortgagor and mortgagee from addressing privately the debt dispute between them. The authors fail to understand the reason for a pre-emptive purchase right for tenants in commercial settings and maintain that the concept should be abolished completely. At the very least, the law should permit lessees to waive any pre-emptive rights that they have *vis-à-vis* any mortgagee of the leased property. Such a provision would preserve whatever values are served by the pre-emptive right and at the same time would permit financings to proceed smoothly in ways that ultimately will reduce costs to tenants as well as to landlords. It might be possible to permit waivers only in the case of commercial tenants. However, the need to give a mandatory pre-emptive purchase right to residential tenants does not outweigh the need to facilitate market transactions.

At least in the commercial area, rigid rules generally should not preclude the parties from relying upon a negotiation process to work out their respective priorities. In America, even though lessees and mortgagees are not necessarily at the bargaining table at the same time, established trade practices have made it possible for each party to assert its economic power to achieve a desired and appropriate relationship.

The scarcity of Chinese housing and the traditional high value that Chinese law has placed on the protection of the home indicate that protection of residential tenants is another matter entirely. The authors would advise Chinese lawmakers to craft special provisions relating only to residential tenants and to permit commercial real estate leases to float freely in the marketplace.

C. *Structural Issues*

Another important problem in Chinese mortgage law is the apparent prohibition of leasehold mortgages. Unlike other features of Chinese mortgage law that the authors have criticized, this feature may not be the result of conscious policy decisions, but may simply be the result of the application of traditional civil law concepts in mechanical ways that ultimately impede flexibility. There is no principled basis upon which to distinguish a mortgage on a long-term leasehold from a mortgage on a land use right in determining the validity of financing arrangements in modern China. Both should be readily permitted. Leasehold mortgages are an important tool for economic flexibility in Western countries and can be in China as well.

The final major difficulty that the authors have identified in substantive Chinese mortgage law is the rule restricting the application of a mortgage to improvements made after the mortgage. The policy foundation for this rule is uncertain. Perhaps there is some anti-speculation policy at work, but the authors cannot discern what it might be. The rule does not appear to be designed to protect the interests of either mortgagor or mortgagee, but rather is a troublesome remnant of excessive bureaucratic control. As the Chinese economy develops, the demand for construction loans will increase. To the extent that the rule, which restricts the attachment of mortgages to subsequent improvements, is identified and enforced against Chinese lenders, it will significantly deter lending and slow development. China should thus move immediately to eliminate it.

In each of the criticisms above, as well as with regard to many other items discussed earlier in this Article, the authors have urged Chinese lawmakers to let the market run. The law should be a frame that sets broad parameters within which the parties can bargain. It should not be a cage that narrowly defines those areas in which bargains are possible. At least in the commercial marketplace, the best loans for all parties are achieved with free

competition, free bargaining, and clear enforcement of the bargains that are struck.

D. Enforcement

For a variety of reasons, Chinese courts have been slow to enforce fully the substantive rights in existing mortgages. Some of this results from the fact that the mortgage loan, especially with regard to mortgages on land use rights and improvements on land, is a new concept in China. As such, the judiciary lacks experience in dealing with mortgage issues. But some of the problems, according to practitioners the authors have interviewed, stem from the lack of a clearly independent judiciary. Although China has a single national court system, the various elements of the system are funded locally and judicial appointments are locally controlled.³⁴² The authors fear that until both the judiciary and the local governments become convinced that a strong, fair, and independent judiciary is in the best interests of all the people of China, all commercial law, including mortgage law, will fail to serve adequately the purposes for which it was designed. When this goal of a fair and independent judiciary is realized, there will be an incentive for the marketplace to press for the minor changes in Chinese mortgage law that are necessary to ensure that the law will meet the needs of the real estate community and carry the national economy forward.

³⁴² Zhonghua Renmin Gongheguo Renmin Fayuan Zuzhifa [The Organic Law of the People's Court] (adopted July 1, 1979, amended Sept. 2, 1983) arts. 11, 35-36, *translated in* THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1983-1986 37-46 (1987).