

NEWSLETTER

IMPACTS OF COLLATERAL RIGHTS ON MOVABLE PROPERTY UNDER THE PRC CIVIL CODE ON INTERNATIONAL SALE OF GOODS



Trade between China and the rest of the world plays an important role in the international economy. Foreign companies selling their products to Chinese companies, or setting up subsidiaries in China to trade with local Chinese companies, need to understand the relevant Chinese laws in order to effectively protect their rights.

In terms of purchase and sale of goods, in addition to the sales law, the regulations of collateral rights over movable property often have an important impact on the stability of transactions. Because of its indirect financing function, this legal regime is listed by the World Bank as an important indicator for evaluating a country's business environments.

The newly promulgated PRC Civil Code (promulgated on May 28, 2020, coming into force on January 1, 2021 and replacing numbers of basic laws of China, such the PRC Contract Law, the PRC Real Rights Law, the PRC Security Law etc.), has made significant changes to collateral rights on movable assets. This article, taking retention of title and mortgage over movable property as examples, provides a brief analysis of the transaction risks and measures to address them.

Impacts of Collateral Rights on Movable Property under the PRC Civil Code on International Sale of Goods



I. RETENTION OF TITLE

In contracts for international sale of goods, in order to secure payment of the purchase price, foreign sellers are often advised to include retention of title clauses in the contract. This legal instrument is also clearly stipulated in the PRC Contract Law (1999), i.e., Article 134, which provides "*The parties may agree in the contract of sale and purchase that if the buyer fails to perform the payment of the price or other obligations, the ownership of the subject matter belongs to the seller.*" On this basis the Interpretations of the Supreme People's Court on Issues Concerning the Application of Law for the Trial of Cases Involving Disputes over Sale and Purchase Contracts (July 1, 2012 Fa Shi [2012] No. 8, hereinafter referred to as the "Judicial Interpretation") has refined this system by stipulating in detail the seller's right to take back the subject matter under certain conditions, the loss of the recapture right, the buyer's right of redemption and liquidation in case the buyer fails to redeem and the seller sells the subject matter to others.

In practice, some of the frequently explored issues in the retention of title include:

1. How to make publicity to retention of title.

In a sales relationship, once the seller has delivered the goods and the buyer taken possession thereof, the buyer's possession can already constitute the appearance of ownership from the point of view of a third party. The ownership retained by the seller, without any form of publicity, appears to be difficult to make known to others and thus difficult to protect. Therefore, how to publicize the retention of title, has been one of the core topics under discussion in the process of formulating the Judicial Interpretation in 2012, which, however, at the end did not provide a solution. So far, the retention of title is still limited to the contractual framework between the buyer and seller. The seller intending to better protect his ownership can only try to resolve it through contractual agreements by, for instance, obliging the buyer to label the purchased movable property, indicating that it is the seller's property. This form of protection is undoubtedly limited.

2. The nature and exercise of the right of recapture and its relationship to the termination of the contract.

In accordance with the provisions of the Judicial Interpretation, provided that the buyer has not paid more than 75 per cent of the total price of the goods, the seller may in some cases, such as the buyer not paying the price as agreed, claim the right to take back the goods. The prevailing view in doctrine and practice regards the nature of this right of recapture as liquidation based on the collateral as such, rather than the termination and liquidation of the contract. Claiming the recapture right does not mean that the contract is terminated and the (paid) price should be returned. Therefore, the seller has the right to choose whether to exercise the right of recapture under the retention of title clause and whether to exercise it prior to, after or together with the contractual claim of price payment.

3. The way of exercise of the right of recapture.

The right of recapture is generally subject to court decisions following litigation proceedings. In the proceedings, the seller's claims include confirmation that the ownership is vested in the seller and that the buyer should therefore return the original subject matter.

Under the framework of the Civil Code, the retention of title is further refined on several aspects.

1. Publicity.

Article 641 of the Civil Code provides that "*Where the ownership of the subject matter retained by the seller has not been registered, the seller may not challenge against any bona fide third party.*" This means that when the Civil Code comes into force in 2021, retention of title will be subject to registration in the same way as other collateral rights on movable property. An important institutional development of the Civil Code in the section on security interests is the envision of future establishment of a unified registration system for security interests in movable property and rights in China. It is still under discussion which authority will carry out this registration and whether it will be compiled in rem or in subject. In any case, in the future, in contracts for the international sale of goods, if a foreign seller



NEWSLETTER

IMPACTS OF COLLATERAL RIGHTS ON MOVABLE PROPERTY UNDER THE PRC CIVIL CODE ON INTERNATIONAL SALE OF GOODS

wishes to secure the price through retention of title, a clear agreement on the buyer's obligation to register this retention will be essential.

2. The right of recapture and the way of its exercise.

Article 642 of the Civil Code adds a new provision regarding the exercise of the right of recapture, namely that the seller may negotiate with the buyer to take back the subject matter; if the negotiation fails, the procedures for realization of security interests may apply *mutatis mutandis*. This provision clarifies, on the one hand, the nature of the retention of title as an atypical collateral right; on the other hand, the path of its exercise, i.e. in the event of failure of negotiation between the two parties, the seller, like other collateral right holders, can, in accordance with the provisions of the PRC Civil Procedure Law on special procedures for the realization of a collateral rights, directly request the people's court to seize or auction the property, rather than requesting the court to rule on the merits of the sale and purchase relationship.

II. MORTGAGE ON MOVABLE PROPERTY

In addition to retention of title, which is the most commonly used security under a sales and purchase contract, buyers and sellers need to pay particular attention to the possible impact of the new system of mortgage on movable property under the Civil Code. From the PRC Security Law (1995) to the PRC Real Rights Law (2007), the legal instrument of mortgage on movables tended to expand its scope of application. Under the PRC Civil Code, the system has been significantly modified, which may have important implications for future market transactions.

Here we can first examine the utility of this collateral right and related issues from the seller's perspective.

1. Sellers may consider using movable property mortgage to secure payment of the purchase price.

Under the PRC Real Rights Law, except for semi-moveable property such as ships, aircraft and vehicles, which have a mature registration system, only the production equipment, raw materials, semi-finished products and products of an enterprise can be registered as mortgaged movable property under the framework of floating mortgages by following the Measures for Registration of Movable Property Mortgages (2019). This makes it impossible to register other chattel mortgages, thus preventing the creation of mortgages that can be effectively used against third parties.

Under the Civil Code, with the establishment of a uniform registration system for security in movable property, the practical scenarios for the use of security in movable property are likely to increase significantly. For example, in international contracts for sale of goods, especially in the case of procurement of large machinery and equipment, if the buyer does not need to immediately pay for the goods, and the seller needs to first deliver the goods and transfer the ownership to the buyer, the two parties may agree that the buyer creates a mortgage on the goods for the seller, and complete the registration to secure the payment of the price.

2. Super-priority.

It is however important to note that under the chattel mortgage contemplated in 1 above, the mortgagee, i.e. the seller, may face a risk that is easily overlooked, that is where the buyer has already created a floating mortgage on its movable property. An earlier-registered floating mortgage may include the production equipment acquired after registration into collateral, making it part of the mortgaged property, and an earlier-registered floating mortgagee may have priority over a later-registered seller in terms of priority of payment.



NEWSLETTER

IMPACTS OF COLLATERAL RIGHTS ON MOVABLE PROPERTY UNDER THE PRC CIVIL CODE ON INTERNATIONAL SALE OF GOODS

In this regard, the Civil Code introduced the so-called "purchase-money security interest (PMSI)" from the U.S. Uniform Commercial Code (UCC), which is known as "super-priority". Article 416 of the Civil Code provides that "*The principal obligation of the security in the form of a mortgage is the price of the mortgaged property, if the subject matter is registered for mortgage within ten days after being delivered, the mortgagee shall be paid prior to other collateral right holders in respect of the purchaser of the mortgaged property, except for lienors.*" That is, if the seller is able to register its mortgage within ten days of delivery of the goods, his right to payment will have priority over all other (except for liens) security interests, including an earlier registered floating mortgage.

From another perspective, imagining that we are the buyer of a contract of sale, how does the chattel mortgage system affect the transaction? Probably the most important implication here is the situation where the traded goods are subject to a security interest.

Under the framework of the Real Rights Law, a mortgagor may not transfer the mortgaged property during the mortgage term without the mortgagee's consent, where a mortgagor transfers the mortgaged property with the consent of the mortgagee, the money generated from the transfer shall be used for the early repayment of debts or be submitted to a competent authority for safekeeping. In other words, the transfer of the mortgaged property requires the consent of the mortgagee and the elimination of the mortgage on the transferred property, so there is no need to consider the issue of recourse on the collateral based on mortgage.

On the contrary thereto, Article 406 of the Civil Code explicitly states that the mortgagor may transfer the mortgaged property during the mortgage period. If the mortgaged property is transferred, the mortgage remains unaffected. This means that in the future, buyers will encounter significantly more properties burdened with third-party mortgages on the market. A mortgage as a right in rem gives the right holder the right of recourse on the mortgaged property, and the buyer is correspondingly more likely to be forced to give up what he has acquired based on the sales contract.

The legal means to counter such a situation seems to be found in another provision of the Civil Code: Article 404 of the Civil Code provides that a mortgage on movable property may not be taken against a buyer who has paid a reasonable price and acquired the mortgaged property in the ordinary course of business. This seems to mean that the mortgagee will not be entitled to recover the object as long as the transaction is in the ordinary course of business and the buyer has paid a reasonable price and acquired the object.

In fact, the content of Article 404 of the Civil Code already exists in the Real Rights Law but is only applicable to floating mortgages, dealing with the uncertainty of collateral in floating mortgages. The conflict between Article 404 of the Civil Code, which now extends to all movable mortgages, and Article 406 is obvious. We may only wait for future judicial interpretations and jurisprudence to clarify this conflict between the two provisions. In the meantime, it is recommended that from 2021, when the Civil Code comes into force and a unified registration system for security rights in movable property is established, buyers should pay special attention to the security rights register at any time during the transaction. In addition, in the sales contract, seller's warranties regarding non-existence of encumbrance of third-party rights should be explicitly stipulated and detailed and supplemented by special liquidated damages, in order to maximize the recovery of loss of property rights.

To sum up, in the upcoming Civil Code era, the seller may continue using the retention of title to secure the price payment. It will be possible to publicly register the retention and the seller should have it done in order to defend himself against a third party. The seller may also require the buyer to set up a mortgage on the goods delivered but not yet fully paid. The mortgage should be registered within ten days of delivery in order to enjoy the super priority. The buyer, on the other side, should be vigilant about possible mortgages on the goods under sales. It is advised to check the security rights register carefully and set forth special clauses in the sales contract to deal with contingent risks related thereto.



NEWSLETTER

IMPACTS OF COLLATERAL RIGHTS ON MOVABLE PROPERTY UNDER THE PRC CIVIL CODE ON INTERNATIONAL SALE OF GOODS

Contacts



Alban RENAUD

Email : alban.renaud@adamas.com.cn



Huini LI

Email : li.huini@adamas.com.cn



Denis SANTY

Email : denis.santy@adamas-lawfirm.com

Offices of ADAMAS

We warmly welcome you to contact with our offices in **Beijing** and **Shanghai**:

Suite 2108, Zhongyu Plaza
A6 North Gongti Road
Chaoyang District
Beijing, 100027
Tel: +86 10 8523 6858
Fax: +86 10 8523 6878

Suite 5J-1, Huamin Empire Plaza
726 West Yan An Road
Changning District
Shanghai, 200050
Tel: +86 21 6289 6676
Fax: +86 21 6289 6672

Moreover, ADAMAS collaborates closely with law firms in Guangzhou, Chengdu, Wuhan and Hong Kong.