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Secured Transactions Under China and US Law

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Abstract

The secured-credit law is key of modern commercial transactions. Under China's Property Law, some aspects in terms of secured transactions have been improved with comparison to Security Law (1995), but it is considered to be unsatisfactory. The purpose of this article is to examine the very significant problems of China law on secured transactions, including the narrow range of the movable collateral, the lack of centralized registration system and the cumbersome enforcement process. For a reference, this paper takes Article 9 of United States Uniform Commercial Code as a model to compare the differences in Secured Transactions between China and US: Article 9 made it possible for secured transactions to be conducted with maximum flexibility and efficiency. Based on the reference point, this research also tries to find out to what extent it could be imported to China.

Key words: Secured transactions; Article 9; Registration; Enforcement

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INTRODUCTION

It is well known that Article 9 on secured transactions of UCC is a paragon of secured-credit law. Many countries all over the world (e.g. Canada, New Zealand, Australia, Mexico, Gaza, and so forth) have followed the Article 9 model to reform their domestic secured-transactions laws.

Even some Central and Eastern European countries with long civil law traditions have embraced key principles of the UCC, in an attempt to develop modern secured financing systems. Moreover, the Article 9 of UCC has influenced remarkably on model secured-transactions laws, such as the Legislative Guide on Secured Transactions (*Guide*) issued by the United Nations Commission on International Trade Law (UNCITRAL). It provides developing countries with a model code, and it also acknowledges the difficulties that may arise in the process of legal reform. It mainly aims to achieve harmonization of international trade and commercial law.

An efficient, workable, and well-enforced secured-transactions law has been widely considered to exert a dramatic impact on economic development and would bring positive results. It allows for individuals or entities to use personal property as collaterals. Specifically, it provides more chances for small and medium enterprises, which rarely have lands and buildings for loans, to enter into the credit markets. Furthermore, it is expected to make marketplace for credit significantly more efficient and facilitate domestic economic growth. In order to make this positive source play a better role in economic growth, the establishment of predictable systems of secured lending through the reform of secured transactions laws is essential.

In this decade, China is also being taking efforts to reform the existing secured-credit law system to keep pace with the demands of the country's rapidly growing economy, including revising provisions of the 1995 Security Law to become part of the 2007 Property Law. This is China's first comprehensive law on ownership and use of different types of property rights. It includes a chapter on security in real and personal property (Su, 2007). However, it is not enough. Many changes should be made to support a modern secured financing system.

In general, this paper will discuss the following four major aspects of secured financing law in China and

US: conception of security interest, scope of movable collateral, perfection and enforcement of security interest.

1. CONCEPTION OF SECURITY INTEREST

Article 9 of UCC “applies to a transaction, regardless of its form, that creates a security in personal property or fixture by contract”. It adopts a unitary concept of security, which replaced the a great variety of security forms and devices that prevailed under the prior laws, each of which has its own characteristics, such as pledge, chattel mortgage, conditional sales agreement, trust receipt and so on. This unitary approach is derived from the drafters’ perception that all security interests perform an identical function and should be subject to an identical legal framework (Bridge, Macdonald, Simmonds, & Walsh, 1998-1999). On a practical level, it is believed that the definition of security interest reduces conceptual questions in practice and improves the certainty of the judgments. For example, the judges would not be bothered by the following question: Whether a particular transaction falls within the definition of security interest.

Nevertheless, there exists uneven reception of this formalism approach. On one hand, Canada, for an example, has accepted it and almost has no substantial changes to the Article 9 of UCC. On the other hand, this approach has been rejected by the lawmakers of some countries. For instance, In UK, there is no general concept of a “security interest” as expressed in Article 9. Secured transactions are differentiated from title retention and consist of certain types. According to classic analysis, English law knows of three nominate consensual securities: the mortgage, the charge, and the pledge. Although the English Law Commission has recommended substantial changes in relation to security devices over personal property, however there seems little evidence of support from the United Kingdom parliament (Steven, 2013). In addition, New Zealand has also followed the American model commenced the Personal Property Securities Act 1999 (NZ) (NZPPSA), but it does not abolish the old forms of pledge, mortgage, fixed charge and floating charge, though; rather, for the purposes of secured transactions law, the NZPPSA abolishes the legal significance of any distinctions between them. Therefore, the old forms of security device may still be employed in New Zealand.

In China, there are also supporters for the view that the conception of security interest should be applied in secured transactions law. However, as far as I am concerned, it is not the best suitable option for china. Various factors contribute to this perspective.

To begin with, China’s legal system largely follows the continental civilian model and has not enacted a comprehensive civil code. Although the influence of

common law systems has become more noticeable in Chinese law in recent years, the fundamental concepts and principles of Chinese civil law originate from the German paradigm. According to the continental legal system, secured transactions law on moveable collateral originates from possessory charge. However, with the rapid development of the economy, it has been gradually lost its actual value. Because it requires physical delivery of the collateral from the debtor to the creditor, which was not fit to the transaction demands in modern commercial practice (World Bank Group, 2007). Consequently, the legal systems for non-possessory security interests have been developed in German, France and Japan and etc., such as title retention and transferring guarantee. China, as a country significantly influenced by German paradigm, it would be better to keep the current state and retained the traditional legal framework on secured-credit law, rather than adopt a completely strange concept, which will probably bring difficulties in application of law.

Moreover, we cannot deny the advantages of the creation of a single universal secured interest: “It facilitates the establishment of a unified publicity scheme, which is designed to help potential creditors determine the priority status of their security interest prior to lending.” Nevertheless, some scholars insisted that functional analysis has not produced clarity. On the contrary, there do exist a high level of confusion on some questions, i.e., what is the essence of a security interest? In addition, it removes the meaningful distinctions of all secured devices and tends to bring all the transactions within the Article 9 only if it satisfied the requirement of regulations. This will occur “even if the transaction is otherwise factually far from the world of secured credit”.

Finally, it would take many years for the public to receive the new concept, particularly in the judicial practice. Since the UCC approach varies greatly from the legal frame of the continental legal system, traditional security devices such as pledge and chattel mortgage, have been replaced. The reform of secured-credit law would proceed on a wholly different conceptual basis to the prior law, which is an entirely new theoretical basis. It would be expected that the novelty of the concept would influence the judicial treatment of the new regimes. The process will take a long time, perhaps at least ten years, according to the reform experience of other countries, to make it possible for the courts to respond to the new concept. Therefore, the lawmakers in China need to weigh carefully the possibilities of adopting the general concept of a “security interest”.

2. SCOPE OF MOVABLE COLLATERAL

As we know, Under Article 9, the range of movable collateral is broad. Movable property of any kind, tangible or intangible, presently owned or after-acquired, can be

used as collateral. The possible types of collateral include goods (consumer goods, farm products, inventory), documents, instrument, chattel paper, investment property, deposit account, and the intangibles (account and general intangibles). The parties of transactions are given the wide freedom to determine the secured debt and the collaterals, especially for the small business financing. They have a great flexibility to arrange their relationship as best suits their needs.

With the implementation of Property law, China has permitted the possibility of mortgage on movable collaterals, which is a breakthrough regulation compared with the German law system, because the German civil code maintains a general prohibition against granting non-possessory security interests in movable property. This reflects that lawmakers of China have noticed the significance of security interest on the personal property. Under Property Law, Article 180 set forth a positive list that can be used as security. More importantly, the last paragraph of Article 180 offered a general provision. It stipulates that any property which is not prohibited to be mortgaged by laws or administrative regulations can be used as collateral. Furthermore, "Article 181 of the Property law make it possible for enterprises, individual industrial and commercial households, and agriculture producers to create a limited scope of floating mortgage over existing and future equipment, raw materials, semi-finished and finished and finished products. Similar to the English common law, the mortgagor has a right to dispose of such goods in the ordinary course of business." (Mark et al., 2010) All of these show great progress made in Property Law with respect to secured transactions.

However, under China's current laws, the movable properties do not play a major role in securing financing for businesses. Movables are less attractive collateral for lenders. A result from a joint People's bank of China (PBOC)-FIAS-CPDF survey of finance for lenders shows that less than 15% of business credits are secured by movables. The prejudice in favor of real estate directly results in the financing woes of small and medium enterprises (SMEs), which do not own the building or land, but hold inventory and equipment as their primary assets instead. By contrast, in the US, movables account for about 70% of small business financing (Su, 2007).

The reasons for the present situation in China involve many respects. The main cause is the restrictive scope of the movable collateral. Despite of the general provision on mortgage, it is too abstract to apply to judicial practice. In addition, intangible collateral is limited to certain rights evidenced by financial instruments and documents, as well as certain intellectual property rights. As we know, the civil law system follows the numerous *clausus* principle, the categories of real rights and their contents shall be prescribed in law. There is no permission of creating a new type of property right which will not be

acknowledged by law. This is also a part of the reason why the scope of the permissible movable collateral is narrow. However, a system of law that largely lacks freedom of contract is more likely to block legal creativity.

What's more, although the China lawmakers have introduced the floating mortgage system, hot debate has been aroused among scholars on it. UK created the floating charge in mid-19th century in the British court of equity in judicial practice. It's a separate device to allow a security interest attaches automatically to a debtor's future and fluctuating assets. The floating charge of UK inspired the later development of the uniform approach in the US. Article 9 does permit a "floating lien" and be similar to the floating charge in that it gives the debtor the ability to freely dispose of the collateral without interference from the secured party, but it is limited to categories of property that are capable of being subject to non-possessory security interest under Article 9. While compared to floating lien, the floating charge is much broader, potentially covering "all the property of the debtor, in all countries of the world". Granted, the subjects who can establish a floating charge have no limitation in US law, but this is due to the mature credit system in US. Even UK with a sophisticated legal system has limited this right to the companies. It is necessary for us to limit the scope of possible subjects, to control risks and guarantee the security of transactions.

3. PERFECTION OF SECURITY INTEREST

An efficient centralized registration system for moveable collateral is very significant and essential of modern secured transaction. Such registration system can not only give a notice to the parties interested in the same personal property; but also help to determine priority status according to the date of registration.

Article 9 provides four means of by which a security interest can be perfected, they are perfection by filing, perfection by possession, perfection by control and automatic perfection. Specifically, filing is the general mechanism for perfection of an Article 9 interest. It is a permissible means of perfection of an interest in almost any type of collateral. The secured party need to create a satisfactory financing statement, get it filed in the appropriate place, and pay the filling fees. Then this security interest in a given debtor's collateral is publicized. It is only required that an initial financing statement provides the following information: (a) the name of the debtor; (b) the name of the secured party; and (c) indicates the collateral that it is meant to cover. Theoretically, once this information is covered, a financing statement is sufficient, without requiring substantial documents and other kinds of information. What's more, electronic filing is becoming more and more commonplace in US, and such electronic

filings often take a few minutes to complete and cost less than \$20. The modern form of filing is an incentive for the filers to publicize their secured interests.

China does not have a centralized registry for all types of movable collaterals. According to the functions and authorities of administrative departments, registration affairs are managed simultaneously by several registries. For example, if the collateral is the existing and future equipment, raw materials, semi-finished or finished products, the registry will be the department of administration for industry and commerce; if the collateral the aircraft, ships, or vehicles, the transportation divisions will take charge of the registration. Therefore, Under the China Law, a lender must navigate through a registration system comprised of more than a dozen individual registries differentiated by the types of movable assets and the status of the debtor. As a result, multiple registrations are required when more than one type of asset is involved. It will probably take a long time for registering secured interests with the appropriate registries, if a borrower uses all of his assets as collateral. Besides, lenders are required to submit excessive amounts of documents and all materials will go through intensive scrutiny by registry officials (World Bank Group, 2007) What's worse, in order to fight for benefits, different registries have competitively issue lots of regulations, which put too much emphasis on their own interests. This situation makes the secured transactions law system more complicated and scattered. These problems make registration inefficient and costly in China, which in turn reduces the enthusiasm of registering.

Along with the development of science and technology, electronic registration has become a trend all over the world, not only for the moveable property, but also for the real estate. It offers us a cheaper and speedy way to accomplish registration process. In China, the lawmakers have realized the necessity to establish a centralized registration system for real estate and will take electronic registration as the main form in the future. It is believed that the government will attach more importance to building electronic registration system for the movable collaterals.

4. ENFORCEMENT OF SECURITY INTEREST

Speedy, effective and inexpensive enforcement mechanisms are essential to realizing security interest. Enforcement is most effective when the parties can agree on the rights and remedies, including seizure and sale of collateral outside the judicial process upon default. The enforcement mechanism of Article 9 is basically a private matter. It gives the secured party the opportunity to apply an effective and speedy self-help regime, without the need to rely on recourse to a court. Although the

secured party bears the obligation to ensure the process is carried out correctly and without a breach of the peace, this is attractive feature of the Article 9 scheme for the lender. More to the point, it is a cheap execution against collateral upon default and provides the surest form of reducing the cost to the lender, which is also the motivating purpose of secured transactions. Furthermore, the secured party has no obligation to notify the debtor that he or she is attempting to repossess the collateral, which is considered as an important factor that makes self-help repossession work best. Otherwise, the debtor would take measures with his or her property ahead of time. As a result, the collateral would not be available for the repossession.

Chinese courts play a main role in the enforcement of security interest. In the event of a default by the debtor, for instance, he or she fails to make a payment when due or provide a service as promised, and it's less likely for the debtor to be able to perform in the future or that will impair the value of the collateral on which the security interest rests, the secured party must seek a judgment and an execution order from the court in order to take possession of the collateral. The seizure and sale of the collateral must also be done by court officials. But usually, most of the enforcement actions will take more than one year to accomplish, due to the complicated and cumbersome progress. During the long period, the value of the movable collateral is likely to be greatly reduced. In addition, it also helps it possible for debtors to hide or fraudulently transfer the collateral. The cost is not limited to court fees, execution fees, taxes, appraisals fees and etc.. (Su, 2007)

Based on the advantages of self-help remedies, it seems that China has the reason to adopt it and employ it into the enforcement. However, we still have to take the disadvantages into consideration. The term "breach of the peace" is nowhere defined or even explained in Article 9 or anywhere else in the Code. There is no simple or single formula for determining when a breach of the peace has occurred. As a result, it's difficult to be understood, but only to look at the relevant cases. As to China, it may cause difficulties in defining the term and is more likely to lead to improper repossession involving a breach of the peace. But we have to admit that the secured parties need more rights to realize the secured interest, rather than only wait to be informed passively by the courts.

CONCLUSION

In general, the Article 9 Model is very facilitating and enabling, and permits the creation of security in all sorts of situations. These advantages lead to make credit markets more accessible and less expensive for potential debtors. The legislative experience of Article 9 has been instructive to the establishment of predictable systems of secured lending in China through the reform of secured transactions laws.

In the light of the tradition of the continental legal system and the ambiguity of the definition of security interest, adopting a unitary concept may not be the optimum choice for China's secured financing law. But this does not mean other aspects of law reform cannot be introduced in China. It is suggested that where benefits are greater than costs in carrying out a reform, a new path will be established. It's essential to broaden the range of movables assets (e.g. inventory and consumer goods) that borrowers can use as security. More importantly, the legislation of secured-credit on personal property must be perfected and specific provisions should be provided in the Property Law. Establishing the centralized registration system will help relieve the disputes rising on the priority of security interest. In addition, unnecessary administrative controls on the registry must be removed. Finally, more rights should be given to the secured creditor during the enforcement process.

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