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Financial Innovation of the Chinese Financial Markets: New Types of Chattel Pledges

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Abstract¹

The author examines some of the difficulties relating to chattel pledges in China from a financial innovation perspective. This article finds that: (i) under current Chinese financial practice, legal innovation exists in pledges over bank accounts and dynamic pledges; (ii) the new types of chattel pledge faces difficulties establishment and implement of a pledge; (iii) the numerus clausus principle is called into question and should be relaxed to recognize the new types of chattel pledges by way of a broad interpretation, and party autonomy should be taken into account in the realization of them.

Key words: Chinese Security; Chattel Pledge; Financial Innovation; Pledge Over Bank Accounts; Dynamic Pledge

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1. RECENT DEVELOPMENTS IN FINANCIAL INNOVATION OF SECURITY INTERESTS IN CHINA

Financial innovation can generally be viewed as the

creation of new financial instruments, which notably includes collateralised debt obligations ('CDOs') whose role in the Great Recession (2007-2009) has been intensively scrutinised. The concept of financial innovation also extends to new financial technologies ('FinTech'), institutions and markets, such as the market for securitisation. As such, financial innovation is a driver for economic growth.

In China, the need for improvement of the financial market, as proposed at the Third Plenary Session of the 18th CPC Central Committee,² has led to financial innovation of security interests³ as these are core to secured transactions. Accordingly, great importance has been ascribed to increased availability of financial services and continued innovation of financial services as the Chinese government seeks to promote and encourage the development of a more inclusive financial market.⁴ Simultaneously, the Chinese government has sought to foster an improved domestic business environment which encourages the development of new financing methods for small and medium-sized enterprises through, for example, innovative movable-pledge loan facilities. Under Chinese law, there are two categories of security interests: mortgages and pledges. In accordance to the Property

² Decision of the Central Committee of the Communist Party of China ('CCCCP') on Some Major Issues Concerning Comprehensively Deepening the Reform (12 November 2013)]

³ The unitary concept of a security interest was first formed in art 9 of United States Uniform Commercial Code ('UCC'). UCC § 1-201 (b) (35) defines a security interest as "... an interest in personal property or fixtures which secures payment or performance of an obligation." This article applies the definition to illustrate a security right in conformity with the following two features. First, its scope of collateral is limited to movable property, including incorporeal property, which excludes immovable property and surety. Second, it can be created only by agreement, rather than by operation of law, such as a lien.

⁴ Notice of the State Council on Issuing the Plan for Advancing the Development of Inclusive Finance (2016-2020) (No 74 [2015] of the State Council)

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Act 2007, a pledge can be attached to chattels and rights.⁵ In light of these developments, new types of Chinese security interests in the form of new chattel pledges have recently emerged, these being (a) pledges over fluctuating bank accounts and (b) dynamic pledges. Both types are analysed in this article.

2. PLEDGES OVER FLUCTUATING BANK ACCOUNTS

Various new types of pledges over bank accounts have been in banking practice which has required the financial system and the judiciary to cope with their new characteristics. When assessing such new situations Chinese courts will generally apply article 85 of the Judicial Interpretation No 44 ('JI44')⁶. In light of this article, a pledge over a special bank account (e.g. an Export Tax Rebate Custody Account or a Special Guarantee Funds Account⁷) is in nature a monetary pledge. As noted elsewhere, an effective monetary pledge must meet two fundamental requirements to be effective: (i) the funds must be specified, and (ii) possession of the funds must be transferred to the pledgee. For these requirements to be fulfilled previous cases have required that the pledged money must be either be (a) separated in a special account, (b) sealed money, or (c) be separated as a special guarantee fund, and the money can not be used for daily clearing (Jin & Jin, 2017). However, following Guiding Case No 54 it is now the acknowledged that pledged bank accounts with fluctuating funds does not prevent the fulfilment of specification of funds, as long as the pledgee obtains control⁸ over and management of a pledged account (Jin & Jin, 2017).

⁵ In comparison, under English law a party would typically create either a pledge, a mortgage, or a charge (either fixed or floating) to secure obligations owed to that party. Whereas equitable mortgages and charges may be defeated by a bona fide purchaser of an asset for value, a bona fide purchaser of a pledged asset will not generally obtain title of the asset, except in certain limited circumstances (see Sale of Goods Act 1979, ss 21-26), as it creates a legal interest which is distinct from an equitable interest. In relation to a security interest over an equitable asset, such as a chose in action over book debt, an equitable mortgage or a charge may instead be used. See Joanna Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (OUP 2000) 82.

⁶ Judicial Interpretation of the Supreme People's Court on Some Issues Regarding the Application of Security Law of the People's Republic of China (Judicial Interpretation No 44 [2000])

⁷ *Anhui Branch of Agricultural Development Bank of China v Zhang Dabiao and Anhui Chang jiang Financing Guarantee Co, Ltd* (SPC Gazette, Guiding Case No 54, 2015) ('Guiding Case No 54').

⁸ A bank account could, for example, be controlled through constructive possession which can be obtained through an irrevocable undertaking from the depositary bank, whereby the depositary bank undertakes to comply with transfer instructions from the creditor related to the deposit account without further consent by the debtor.

3. DYNAMIC PLEDGES

The dynamic pledge is a new type of security, which has been developed by commercial banks with the help of logistics service providers. It is especially suitable for the financing needs for micro and small enterprises as it inter alia aids a speedier up capital turnover. The dynamic pledge, or 'dynamic pledge of inventories' or 'dynamic pledge of movables' as it is sometimes referred to, is essentially a security over a category of assets, typically stock such as raw materials, semi-manufactured goods and finished products, which, subject to the secured party's consent, allows the pledgor to deal with the pledged assets in the ordinary course of business (Huang & Wang, 2016). In practice the main operating mode of a dynamic pledge is typically as follows:

- the borrower (i.e. the pledgor) applies with the lending bank (i.e. the pledgee) for a credit or loan facility with the borrower's inventories as put forward as collateral;
- the bank determines the minimum value required for the credit or loan facility;
- for the duration of the pledge, (a) if the actual value or quantity of the pledged assets exceeds the contractual minimum requirement, the borrower would be entitled to apply with the lending bank to release the excess value or quantity, or (b) if the actual value or quantity of the pledged assets is less than the contractual minimum requirement, the borrower would be required to either (1) deposit any shortfall with the lending bank, (2) return the corresponding amount from the credit or loan facility, or (3) supplement the security with the same or similar kinds of assets to make up any shortfall in value or quantity; and
- in the situation where the borrower is in default, the lending bank would have the right to realise its security interest in the pledged assets through a sale of the collateral. (Liu, 2017)

In practice, a logistics service provider typically acts as the custodian of the assets pledged, and, in relation to inventory, three different models of custody have been emerged under current Chinese practice. Firstly, where the collateral is stored in a warehouse controlled by the logistics service provider, the pledgee (ie the lending bank) would typically appoint and instruct the logistics service provider as its agent to possess and custodian of the pledged assets. Secondly, where the pledged assets are warehoused by the pledgor, the logistics service provider would typically be appointed the pledgee's custodian responsible for supervising and administrating the pledged assets by renting the financing enterprise's warehouse or part thereof for a symbolic amount. Thirdly, where the pledged assets are warehoused by a third-party, the logistics service provider would typically rent the third-party's warehouse or part thereof for a symbolic amount and would take custody of the pledged assets (Lu, 2016).

In summary, compared with a traditional pledge, a dynamic pledge has two characteristics. Firstly, the portfolio of assets pledged is dynamic. That is, for the duration of the pledge, the variety, type, quantity and value of pledged assets may change, since the pledgor is permitted to dispose of the collateral within any agreed range. Secondly, a third party would be appointed through a tripartite agreement, and such third party would bear the responsibility of supervising and administering the pledged assets. Accordingly, any release and replacement of property pledged is under strict control to ensure the financing interests of the pledgee.

4. LEGAL CHALLENGES RELATING TO THE NEW TYPES OF CHATTEL PLEDGES

The *numerus clausus* has long been regarded as a basic principle in Civil Law countries. It is also clearly stipulated in article 5 of the Property Act 2007. Under this principle, parties can only establish property rights in accordance with varieties and contents of the property rights clearly defined by law. The new forms of property rights that created arbitrarily and different from the law or to change the contents of property rights would be invalid. This is because property right is the exclusive right of direct control enjoyed by the holder, which can only be effectively protected when the type and content of the property are absolutely clear (Wang, 2008). And, the object of a property right must be a specific property, otherwise the possession or disposal of the property may not be exercised. However, as noted previously, no matter in the cases of pledge over floating bank accounts or dynamic pledge, pledged asset is floating, rather than specific.

According to the Property Act 2007 enterprises, individual industrial and commercial households and agricultural production operators are able to create a floating charge on manufacturing facilities, raw materials, and semi-manufactured goods and products. Consequently, it has been argued that the new types of chattel pledge are legitimised under the theory of floating charges as supported by the Property Act 2007 (Qi, 2015). Under English law, a floating charge has three characteristics: (i) the charge is not attached to any specific asset, but to a pool of assets owned by the chargor, present and future; (ii) the charged assets may change in the ordinary course of the chargor's business; and (iii) the chargor may deal with the charged assets freely until crystallisation occurs.⁹ The hallmark of a floating charge is the third characteristic, whereby the charger has the ability to deal

freely with the charged assets until crystallisation.¹⁰ As noted by Worthington, if the chargor can deal with the charged assets on the chargor's own account without reference to the chargee, the arrangement is a floating charge. Therefore, when classifying a charge, the focus is on whether assets may be removed, and not if assets may be added (Worthington, 1997).

Observing the practice of the dynamic pledge and pledge over fluctuating bank accounts, they share similarities with the English floating charge, under which the charged assets are allowed to fluctuate. For this reason, the dynamic pledge has also been referred to as 'floating pledge' in Chinese jurisprudence.¹¹ However, it differs fundamentally from the floating charge as it does not share the hallmark of a floating charge, as the secured assets cannot be dealt with freely by the debtor. Instead, for the new types of pledge the pledgee usually takes control of the collateral and impose restrictions on the pledgor's use of the collateral. Seen in this light, pledge over fluctuating assets has no clear legislative basis in China under the *numerus clausus* principle.

Further complication arises in that the new types of chattel pledge challenge the traditional principle of property rights disclosure. With regard to chattels, a pledge is established when the pledgor transfers possession of the pledged property to the pledgee. According to the civil law concept of possession, the establishment of a pledge requires the pledgee to have complete control over the pledged property, eg by physical transfer of a movable property to the creditor's possession. This is also a way for the pledgee to urge the debtor to perform on the debt as the pledgor seeks the return of the asset. Yet both a pledge over a floating bank accounts and a pledge over floating goods do not require exclusive and absolute control over the pledged property. During the loan period the debtor would then typically retain the right to access the collateral. In addition, as noted above, a dynamic pledge over floating goods usually operates by introducing a third-party logistics enterprise. In the case where the pledgor keeps the direct possession of the pledged goods and the logistics enterprise performs supervisory duties, it would result in a failure to comply with current property law, since it possibly constitutes a change in possession. However, in line with the traditional theory of property law, possession transfer can be achieved by way of easy delivery of ideas, instruction delivery, but not possession change. Therefore, for the case aforementioned related to the dynamic pledge is not in accordance with the current law system.

In addition to the abovementioned, difficulties

⁹ *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284, cf *Royal Trust Bank v National Westminster Bank plc* [1996] BCC 316.

¹⁰ *Agnew v Inland Revenue Commissioner* [2001] 2 AC 710; [2001] UKPC 28, [13] (Lord Millet), cf *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142; *Tailby v Official Receiver* (1888) 13 App Cas 523.

¹¹ *Ganzhou Bank Co., Ltd. v. SanRui Technology (Jiangxi) Co., Ltd*

in implementation of the new types of chattel pledges exist – in particular in relation to security over banking accounts. To the extent that an obligor fails to pay debts which are due or where other circumstances would allow the pledgee to realise his security exists, the pledgee may seek to exercise his security.¹² Where the security relates to movable property, on a default the pledgee may seek to realise a security by converting the pledged asset into money or by seeking preferred payment from any money realised from an auction or sale of the pledged asset, provided that the pledgee has given due notice to the pledgor. In comparison, where a debtor defaults on an obligation secured by bank account collateral, such security is more easily enforced as realisation of the pledged bank account would simply require a transfer of money. And, in practice agreements will contain a *lex commissoria*-like clause, whereby the lender has the right to directly transfer the funds in the pledged bank account to an account designated by the lender upon the pledged bank's default. However, in the enforcement procedures, it is often the case that a debtor will object to the enforcement of the security exactly because of the existence of a *lex commissoria*-like clause, whereby the agreement would violate the fluidity contract prohibition stipulated in Article 211 of the Property Act 2007 (Chen, 2017).

5. WAY OUT OF THE NEW TYPES OF CHATTEL PLEDGE

A survey by the Supreme Court of China shows that especially small and medium-sized commercial banks and small credit companies have strong business innovation drivers for new types of movable-pledged loan business. However, due to the difficulties in establishment and implementation noted above, the courts, especially the local courts, have generally been unwilling to determine the legal effects of the new pledges by way of judgment (Du, 2018). In response to the development of financial innovation practice, an open-ended and flexible pledge system is required, as the working party of the Financial Law Committee of the City of London Law Society indicates that four principles should inform a modern security law: (1) simplicity; (2) flexibility; (3) freedom; and (4) transparency. Flexibility means the law should be sufficiently flexible to meet the needs of commerce. This leads to the third principle: the freedom of the parties to structure commercial transactions as they wish (Steven, 2013).

With regard to Chinese property law, the *numerus clausus* principle should be allowed to be relaxed. In the ongoing legislative process of the Chinese property law and the Civil Code, the *numerus clausus* principle is

increasing called into question by Chinese writers (Zhang, 2006). However, an entire abolition of this principle or an adoption of “the freedom of property rights” is not practical for the Chinese lawmakers. A less drastic strategy involves *numerus clausus* relaxation, which means for the new property rights, if they are not inconsistent with the legislative purpose of the *numerus clausus* principle, and perfected in a method, they should be recognized by a broad interpretation of the *numerus clausus* principle (Xie, 1999). As mentioned above, article 5 of the Property Act 2007 is about the principle of *numerus clausus*, which provides that the varieties and contents of property rights shall be stipulated by law. Literally, the “law” in this article refers to legal rules, and this ambiguity makes it possible to apply a relative relaxed interpretation. The “law” of *numerus clausus* principle could cover laws, administrative regulations and judicial interpretations (Zhang, 2017). In view of the extensive applicability of the new types of chattel pledge in financial credit practice, and the Chinese court's different attitudes towards them, judgment guidance and detailed provisions can be offered by way of judicial interpretation of property right law. As to the implementation of the new types of chattel pledges, property law should not impose undue constraints thereon.

CONCLUSION

This article has analysed the Chinese chattel pledge in light of financial innovation in China. Financial innovation has given rise to various new forms of chattel pledges. In practice, two new types of chattel pledges are commonly used: the pledge over bank accounts and the dynamic pledge. With regard to pledges over bank accounts, the Guiding Case challenges the traditional view and as it holds that a pledge can validly be taken over a fluctuating bank account. With regard to dynamic pledges, the pledged portfolio of assets may be fluctuating as it is diminished and replaced throughout the ordinary course of business. The two new chattel pledges are subject to difficulties in establishment and implementation. On one hand, a pledge over fluctuating assets has no clear legislative basis, and challenge the traditional principle of disclosure of property rights. On the other hand, the fluidity contract prohibition may be violated by the method of implementation of pledges over bank accounts. However, if taking a practical approach, a relaxation of the *numerus clausus* principle should be allowed and the new types of chattel pledges should be recognised by a broad interpretation of the *numerus clausus* principle. On the implement level, party autonomy should be respected.

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¹² Property Act 2007, Art 219.

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