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New Contractors' Lien Rights In The PRC

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A recent Supreme People's Court interpretation of Article 286 of the PRC Contract Law has significantly strengthened construction contractors' lien rights in China. Article 286 essentially allows a contractor who has not been paid to auction off the project or convert it into value to obtain priority payment. This will be an important commercial advantage for contractors and at the same time presents a key concern for employers and project financiers.

The Court said numerous things in giving its interpretation. Among them, it stated that this preferential lien right ranks higher than a mortgagee's rights. This is far reaching and would extend to lenders who have taken security over any project assets in the PRC.

Under PRC law, liens are generally dealt with in the Security Law which provides an unpaid creditor with a similar remedy of auctioning off or converting the property into value and being paid in priority. However, the Security Law is quite different from the Contract Law in that Article 286 of the Contract Law is intended to deal separately with contractors' liens, while the Security Law provisions deal generally with so-called possessory liens. As the name implies a possessory lien would be the kind for example a contractor could exercise over goods or materials in his possession, not the project itself as a whole. It can thus be seen how one has moved from rights in the movables

on the project to rights in its immovables, or real property (indeed the project itself).

The Contract Law provision confers a prima facie right on a contractor to have the project auctioned and to have claims in relation to price and payment discharged on a priority basis to other creditors. The Court has expressly stated in its interpretation that this right ranks even in priority to the rights of mortgagees, notably the project's lenders. This would typically include lenders who have taken security over the project's assets. It is a right that may be invoked by both contractors (and probably sub-contractors) in cases of non-payment.

The effect of this interpretation is to confer on PRC contractors "North American-style" lien legislation protection. It is interesting that China has taken this route when other jurisdictions such as the United Kingdom have recently canvassed the issue and rejected the notion of lien legislation. Construction law practice in North America would indicate that there is some commercial leverage associated with lien rights which contractors do not possess in non-lien jurisdictions, for example Hong Kong. Therefore, to this extent, there is a redrawing of the risk boundaries on PRC projects that was not apparent prior to the Court's interpretation being handed down. The extent of its impact on commercial transactions, other than residential construction projects, will depend on how the Courts will implement the interpretation in practice. For example, it is still an open question at present whether all categories of PRC construction projects are covered. The true effect of the interpretation will become clearer as this and other questions are answered in practice.

The interpretation will have a significant effect on the parties' negotiations in future deals. It can be expected that additional attention will go into a number of issues in particular to address any questions or uncertainties surrounding the interpretation. It is likely that attention will focus upon matters including waiver, security, subordination, choice of law, and subcontracting arrangements. It will fall to the parties and their advisers to thus work out the effect of the new leverage given to contractors in drawing up their contracts.

In summary, contractors' liens, which date back in fact to the construction of Washington, DC, have long been a hot topic. Now, it's hot in China as well.