

SECURITY IN PROJECT FINANCE FOR THE PETROLEUM INDUSTRY OF THE PEOPLE'S REPUBLIC OF CHINA

This article considers the conflict of laws rules determining the applicable law in the transferring of proprietary interests in assets situated in the People's Republic of China when the governing law of the loan contract is New York/English/Hong Kong law. It also discusses the emerging mortgage law of the PRC in the context of its application to petroleum project financing.

I. INTRODUCTION

At present 'project finance' has yet to be used to finance petroleum projects in the People's Republic of China (PRC). So far, foreign loans to finance petroleum projects in the PRC are in the form of a term loan supported by a guarantee that if the borrower fails to repay the loan the guarantor will. The difference between a term loan and a 'project finance' loan is that the former is lent on the strength of the borrower's credit standing whereas the latter is lent based, mainly but not exclusively, on the credit viability of the project. In the case of a term loan, the bank's credit analysis focuses primarily on the credit standing of the project sponsor. The credit viability of the project is only of secondary importance as the lender has full recourse to the project borrower directly, or through a guarantee for the whole loan. 'Project financing', when used in its restricted sense, refers to a mode of financing where the lender looks primarily, but not necessarily exclusively, to the cash flows from the project being financed for repayment.¹ The credit standing of the project sponsor is important to the creditor only to the extent that it affects the project sponsor's financial ability to fund cost overruns and fulfil its obligations under guarantees of support for the project.²

In the case of a loan supported by a full guarantee (*i.e.* the guarantor assuming the repayment responsibility when the borrower defaults), no complicated structuring of the loan transaction needs to be made. This is not the case in a project financing. The structure of a petroleum project financing transaction is complex and depends on the circumstances of the project sponsors,³ the requirements of the lenders and the situation

¹ When used in its broad sense 'project financing' covers any financing raised by a company to fund a specific project.

² In this article, the term 'project financing' is used in its restricted sense.

³ The project being financed is generally owned by a vehicle company and the project is sponsored by oil companies who hold shares in the vehicle company.

in the country where the project is situated.⁴ Normally, a vehicle company with limited assets is set up to act as the borrower. The actual borrowers are the project sponsors who hold shares in the vehicle company. Support is normally required from the project sponsors, for example, in the form of a 'completion guarantee',⁵ 'take-out' guarantee,⁶ or a 'minimum price guarantee' for the crude oil produced.⁷ These guarantees are different from the guarantee in a term loan in that the former are narrower in scope.

II. SECURITY OVER PETROLEUM ASSETS

In a petroleum project financing, the security package would normally include:

- (1) every single tangible asset, whether existing or after-acquired, of the project;
- (2) the borrower's rights and benefits under all contracts related to the project, for example, long term petroleum sale contracts;
- (3) borrower's patent rights and licences, which are used in the development of the project;
- (4) all crude oil and natural gas produced by the project; and
- (5) all other undertakings, goodwill, as well as property and assets of the project owner whatsoever and wheresoever, both present and future.

As the lenders are looking primarily to the project for the repayment of the loan, it is important to them that they have a security interest over all assets of the project. In a term loan supported by a full guarantee the lender can look to the guarantor for repayment of the loan and therefore security over the assets of the borrower if taken is only of secondary importance.

⁴ Such as the accounting practices, and the financial regulations of the country where the project is situated.

⁵ This commits the project sponsors to ensure completion of the project by a certain date and to inject equity or subordinated funds, as necessary, to ensure this.

⁶ A 'take-out' agreement is one whereby the project sponsor guarantees that on the occurrence of certain specified events the project sponsors shall buy out the syndicate of lenders at par.

⁷ If the market price of the oil produced is below the guaranteed price the project sponsors will have to pay the difference to the lenders.

III. FOREIGN GOVERNING LAW

An international loan transaction involves complex legal issues which the developing Chinese legal system is presently inadequate to cope with. International banks normally negotiate for the loan contract to finance a project in China to be governed by the law of a major financial centre with a well developed system of financial law, a law familiar to the lenders. A syndicated commercial loan to finance a project in the PRC, provided by a syndicate of international banks, is often documented in an agreement governed by the laws of New York, England or Hong Kong.⁸

Article 5 of the Foreign Economic Law of the PRC 1985 (hereinafter FECL 1985) allows foreign economic contracts to be governed by a foreign system of law. It provides:

The parties to a foreign contract may choose the law applicable to the settlement of disputes arising out of the contract. In the absence of such a choice by the parties concerned, the law of the country which has the closest connection with the contract applies. The equity or contractual joint venture contracts and the contracts of cooperative exploration and development of natural resources which are performed within the territory of the PRC must be governed by the law of the PRC.⁹

The 'foreign governing law' exception in Article 5 does not prevent loan agreements relating to petroleum projects in the PRC from being governed by a foreign law, as the exception does not extend beyond the petroleum contract between the China National Offshore Oil Corporation (CNOOC) and the foreign oil companies which gives to the latter contractual rights to carry out exploration and exploitation in the PRC's offshore areas.

Support for this view can be found in an official statement of the Supreme People's Court entitled, "Response of the Supreme People's Court to Certain Questions Concerning the Application of the Foreign Economic Contract Law".¹⁰ Paragraph 2(6) of this statement sets down

⁸ The financial law of Hong Kong is very similar to that of England. The reason why the laws of Hong Kong are chosen is because of its close association with the PRC. In cases where the term of the loan extends beyond 1997, lenders tend to shy away from using the laws of Hong Kong.

⁹ The PRC only recognises the original Chinese text of its legislation as the authoritative text. All English translations of Chinese legislation even when provided by a state department are generally referred to as 'unofficial'. The writer has also translated into English, extracts of other Chinese documents and texts used in this article while other English translations are taken from various sources.

¹⁰ Issued on the 19th October 1987. Hereinafter to be referred to as the "Application of the FECL".

guidelines for determining the proper law of a foreign contract where parties to the contract fail to select the law applicable to the contract. Paragraph 2(6)(ii), in particular, states as follows:

In case of a bank loan contract or guarantee, the law of the region of the bank which is supplying the loan or guarantee shall apply.

Foreign currency loans to the PRC are often booked abroad so in such cases "the law of the region of the bank supplying the loan" would be a foreign law. As paragraph 2(6)(ii) does not exclude loans to finance a petroleum project in the PRC, one may conclude that the use of a foreign governing law in a petroleum loan agreement is not prohibited.

A. Jurisdiction

What is unclear from Article 5 of the FECL 1985 is the scope of the foreign governing law clause. The question of the scope of the foreign governing law is only relevant if the forum for the litigation were to be a People's Court of the PRC where the Chinese conflict of laws rules would be applied. Paragraph 2(5) of the 'Application' of the FECL clarifies the situation: the foreign governing law "shall be the actual law currently in effect and shall not include conflicts of law or procedural law."

Where the forum of litigation is outside the PRC, for example in Hong Kong, then the scope of the foreign governing law in the petroleum loan contract will be determined by the conflict of laws rules of the forum (*i.e.* in Hong Kong). Though there is no mention in the Foreign Economic Contract Law or elsewhere that parties to a foreign economic contract may choose to submit to a foreign jurisdiction it seems, in practice, that the Ministry of Foreign Economic Relationship and Trade (MOFERT) does not object to the inclusion of a foreign jurisdiction clause.¹¹

The foreign jurisdiction normally chosen is the jurisdiction of the chosen governing law, as it is the jurisdiction with the best knowledge of the chosen foreign law. Thus, the foreign jurisdiction normally chosen is Hong Kong, England or New York.

B. Scope of the Governing Law Clause

The following discussion is undertaken in the context of a situation where a project finance contract to finance a petroleum project in an offshore area of China is governed by English/Hong Kong law and a foreign jurisdiction clause is incorporated whereby the parties agree to submit to the non-exclusive jurisdiction of the English/Hong Kong courts.¹²

¹¹ All foreign economic contracts have to be approved by the MOFERT.

¹² The financial law as well as conflict of laws rules of Hong Kong and England are very similar.

Under the conflict of laws rules of England and the United States, the governing law of a contract governs the contractual rights and obligations arising out of the contract. It does not, however, cover every single aspect of the financing transaction. This is where the problem lies. Foreign lenders of a loan to finance a petroleum project in the PRC cannot free themselves from all legal problems merely by choosing a foreign law to govern the loan agreement owing to the fact that the Chinese law on security is incomplete. In other words, even when a petroleum project loan contract is governed by a foreign law, one still needs to take account of the security law of the place where the assets are situated and the extent to which the law of the *situs* governs the securing of the borrower's assets in the lender's favour. The situation would be much simpler if the law chosen by the party to govern the loan contract is all-embracing, covering all aspects of the whole financing transaction, including the transfer of proprietary interests in the borrower's assets by way of security.

IV. TAKING SECURITY OVER ASSETS OF A PETROLEUM PROJECT

Assets of an oil company can be divided, under English private international law, into 'immovables', 'corporeal moveables' and 'incorporeal moveables'.¹³ The following are examples:

Immovables: land and buildings.

Corporeal moveables: petroleum produced, moveable development and production facilities.

Incorporeal moveables: the foreign oil company's interests in the petroleum contract with the China National Offshore Oil Corporation (CNOOC).

The main purpose in taking security in any loan transaction is to provide the lender with the right to resort to some property which it could sell or assign for the satisfaction of the debt in the event of default. The consequence of this is that the lender does not have to depend entirely on the solvency of the borrower for the recovering of the loan. In the case of petroleum project financing the project owner is usually a vehicle company with limited assets. The borrower's assets are those specifically designed for the development of the oil-field concerned,

¹³ This classification is slightly different from that under English property law where the property is classified according to the form of remedy available to the wronged owner of the property.

so the tangible assets of the project have limited resale value if the debtor defaults because of the failure of the project. The only major assets which would have resale value in an offshore project are the pipelines and the shore terminal, provided they could be used to service other fields in the area. The security of the lender in such a situation is generally referred to as 'defensive', *i.e.* preventing the attachment of the project assets by other creditors of the vehicle company.

1. Security over immovables

Under English private international law, the law governing the mortgage of immovables is the *lex situs*. It has been said that the situation where a foreign law can intervene in matters affecting security over land in foreign territories is almost non-existent.¹⁴ Thus, despite the fact that the governing law of the loan agreement is not Chinese law, the grant of a mortgage over land use rights¹⁵ in the PRC would have to comply with Chinese mortgage law. The problem is that there is at present no national mortgage law in the PRC. Moreover, Article 30(1) of the Law on Civil Procedure 1982 reserves to the People's Court of the PRC the exclusive jurisdiction over real property in China. So even if the lenders obtained a foreign judgment with regard to a mortgage over land use rights in the PRC, it could not enforce the judgment in the PRC.

2. Security over corporeal moveables

Under English conflict of laws rules, the law which governs the transfer of an interest in corporeal moveables by way of security, and which moveables remain constantly in one jurisdiction, is the *lex situs*. In the case of corporeal moveables which are not stationed at one place, *e.g.* an oil tanker, or a mobile drilling rig, the proper law is the law of the flag. Such petroleum assets which are constantly on the move do not normally belong to the owner of the project, but are often the assets of the contractors providing services to the operator of the project.¹⁶

For petroleum assets which are stationed in one place in the PRC, including the sea areas under its jurisdiction,¹⁷ the proper law which will govern the security is the law of the PRC, irrespective of the fact that the foreign loan contract is governed by English law.

¹⁴ See Philip Wood, *Law and Practice of International Finance* (1980), subsection 15.3(1).

¹⁵ In China, land cannot be mortgaged as it belongs to the state. Only land use rights may be mortgaged; see Article 10(iv) of the 1982 Constitution (as amended).

¹⁶ The operator of a petroleum project is the member of the cooperative joint venture which is given the responsibility of managing the operation of the project on behalf of the rest of the members of the cooperative joint venture.

¹⁷ The legal situation is more complicated with regard to assets situated in the continental shelf because, under international law, the PRC does not enjoy sovereignty over its continental shelf. The legal issues regarding offshore jurisdiction will not be discussed here.

3. Security over incorporeal moveables

The most important incorporeal moveable asset of the petroleum project which is being financed is the contractual right to have a share of the oil recovered. Other incorporeal moveables which the lender would require to be secured in their favour are:

- (1) the insurance policies for the project;
- (2) the project's accounts receivable;
- (3) all licences, permissions, consents and approvals obtained for the purpose of or in connection with the development of the project (in so far as the law allows any of them to be used as security); and
- (4) the benefits of all contracts entered into by the project company for the purpose of, or in connection with, the project funded by the loan, for example, a sales contract for the petroleum produced by the project.

It is in the taking of security over the incorporeal moveables of a petroleum project that the complexity of the legal position under English private international law is most striking. This is because English conflict of laws rules make fine distinctions with respect to the following aspects of an assignment:

- (1) assignability of the incorporeal moveables;
- (2) the formal validity of the assignment, *i.e.* the formalities which the assignment has to comply with to be effective, for example, assignment before a notary;
- (3) essential validity of the assignment, for example, the requirement, of consideration under English law; and
- (4) the priorities of competing assignments.

Under English private international law, the assignability of incorporeal moveables is governed by the law under which the incorporeal moveable was created and not by the governing law of the contract of assignment, *i.e.* the debenture. Thus, in the case of the assignment of the borrower's interest in the petroleum contract to the lender by way of security, it is the law of the PRC rather than the governing law of the debenture,

since the incorporeal immovable, *i.e.* the right to a share in the petroleum recovered, is created under Chinese law.¹⁸

Though under English private international law the parties to a contract may under the authority of *Vita Food Products v. Unus Shipping*¹⁹ choose what law to govern the contract, the scope of this governing law only covers those aspects of the transaction which fall within the jurisdiction of contract law but does not extend to cover the transfer of proprietary rights which affect the rights of a third party. Thus, where a debenture is governed by English law a lender will need to ensure that the assignment of an incorporeal moveable by way of security complies with the law under which the incorporeal moveable is created.

Where the incorporeal moveable is created under Chinese law, then the lender has to ensure that the assignment by way of security complies with Article 91 of the General Principles of Civil Law:

A party to a contract shall obtain the prior consent of the other party to the assignment of rights and obligations of a contract, fully or partially, to a third party, and there shall not be any, profiteering. If the contract is subject to the approval of the state as the law specifies, approval of the original approving authority shall be obtained, unless otherwise specified by the law or in the contract.

Thus, assignment of rights in the petroleum contract is subject to the prior consent of CNOOC in the case of offshore projects and the consent of China National Offshore Oil and Natural Gas Corporation for onshore projects. Also, the approval of the MOFERT has to be obtained before an interest in the petroleum contract can be assigned by way of security to the lender.

4. *Limits on freedom of choice*

The system of law chosen by the parties to the loan contract to govern the contract of assignment only governs the essential or general validity of the assignment and may also govern the formal validity of the assignment. Questions such as the assignability of the incorporeal moveable, and ranking of priorities, fall outside the scope of the governing law of the contract of assignment.

¹⁸ The governing law of a petroleum contract between the CNOOC and the foreign contractors must always be Chinese law, as required by Article 5 of the FECL and Article 3 of the Regulations of the PRC on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises 1982.

¹⁹ [1939] A.C. 277.

V. SECURITY LAW OF THE PRC

As the transfer of a proprietary interest by way of security over immoveables (and also in some respects security over moveables) has to comply with the law of the PRC, irrespective of the fact that the governing law is not Chinese law, one has to consider the provisions in Chinese law regarding the transfer of proprietary interest. In China, the security devices that may be used to secure a debtor's assets are "mortgage" and "lien". Whereas a "mortgage" in Chinese law is the product of an agreement, a lien arises by operation of law.

Article 89(4) of the General Principles of Civil Law authorises a creditor in possession to exercise a lien over the assets of the debtor:

Where one party according to the terms of the contract has possession of the other party's property, if the other party defaults in repayment of the debt, the party in possession has the right to retain and to sell or otherwise to dispose of it after its value has been appraised.

Legislative authorisation for the taking of a mortgage is found in Article 89(2) of the General Principles of Civil Law:

The debtor or a third party may offer certain property as security. If the debtor fails to repay his debts, the creditor may, through the lawful process, have priority of compensation in cash at the same value as the security or from the proceeds realised therefrom.²⁰

A. Chinese Mortgage Law

Though China's security law is still in an embryonic stage, with no national code on mortgages, it is slowly developing. In the past, one could not have a mortgage over a lease,²¹ but the 1982 Constitution of the PRC has been amended to allow mortgages over leases. At present, legal provisions on mortgages are found in Articles 80, 81, 89, of the General Principles of Civil Law; and paragraphs 112 to 117 of the Opinion of the Supreme People's Court on the General Principles of Civil Law²² (adopted by the Judicial Committee of the Supreme Court on January 26th 1988); as well as local mortgage statutes, applicable only in the limited area concerned.

²⁰ Until the introduction of the 'responsibility system' in the management of state-owned enterprises (which depends on the state to fund all the costs and shoulder all the losses), the requirement of security from a state-owned corporation by its lenders, the state-owned banks, was of little practical relevance. This is because the lending bank was not there to make profits. They function as cashiers of the State and not as businesses. Furthermore, liquidation or bankruptcy did not then exist.

²¹ Before the amendment of the 1982 Constitution, leases or land use rights did not exist in China.

²² Hereinafter, *Opinion on the Civil Law*.

1. *Property not mortgageable*

Sometimes, a particular asset of a project may not be mortgageable under the law of the country where the asset is situated. In Norway, for example, a petroleum production licence was, until 1985, incapable of being mortgaged. In the PRC, the following types of assets of a petroleum project are not mortgageable.

(1) Land

Article 80 of the General Principles of Civil Law prohibits "any purchase, sale, lease, mortgage or illegal assignment of land".

The 7th National People's Congress in 1988 amended the 1982 Constitution of the PRC so that "land use rights" or leases may be assigned. The amended version of Article 10(iv) of the 1982 Constitution provides as follows:

No organisation or individual may misappropriate, buy or sell or use other unlawful means to assign land. Leases may be granted or assigned in accordance with the law.

Under Article 33 of the Granting and Assigning Leaseholds in State-Owned Urban Land Tentative Regulations 1990,

When the leasehold is mortgaged, the structures and other fixtures on the land are mortgaged along with it. When structures and other fixtures on land are mortgaged, the land necessary for their use shall also be mortgaged.

A lender in taking a mortgage over the 'land use right' of a state-owned oil enterprise has to ensure that Article 45 of the Granting and Assigning Leaseholds in State-owned Urban Land Tentative Regulations²³ has been complied with. Article 45 deals with the mortgage, leasing and assigning of 'allocated leaseholds', which refers to the right to use land that is acquired without giving value. This would include the land presently held by the state-owned oil enterprises. The conditions to be satisfied for an effective mortgage of 'allocated leaseholds' held by a state-owned enterprise are:

- (1) approval has been given by the relevant land administration and real estate administrative departments; and

²³ "Urban state-owned land" includes mining areas: see Article 2 of the Regulations.

- (2) the mortgagee has been granted a certificate for the use of the state land, and has paid value for the right to use the land and the structures and fixtures thereon.

In other words, before a state-owned enterprise can mortgage to its lender its land use right, it has first to acquire it from the state for value, *i.e.* paying a price for it.

(2) Mineral resources

Article 81 of the General Principles of Civil Law provides as follows:

Any purchase, sale, lease, mortgage or illegal assignment of mineral resources and water owned by the State, forests, mountains, grasslands, undeveloped areas and beaches owned by the State or by collectives governed by the law is strictly prohibited.

The term "natural resources" used in the General Principles of Civil Law and the Mineral Resources Law of the PRC has never been defined in any legislation. However, Article 1 of the Administration of Petroleum and Natural Gas Survey and Drilling Registration Tentative Procedures (1987) provides thus:

These procedures are promulgated to strengthen the management of petroleum and natural gas survey and exploitation and to hasten the development of the petroleum industry. These regulations are promulgated in accordance with the Mineral Resources Law of the PRC and the relevant regulations on registration of mineral resources survey and exploitation.

Article 1 leads one to think that "mineral resources" include oil and natural gas.

Mining rights

Whereas Article 81 of the General Principles of Civil Law prohibits mortgage of mineral resources themselves, presumably mineral resources in situ, Article 3 of the Mineral Resources Law goes a step further by providing that:

The right of mining shall not be assigned, leased or pledged as a security.

If the right of the foreign oil company under the petroleum contract to carry out exploration and exploitation in cooperation with CNOOC is a mining right, then it would not be mortgageable under Chinese law. It is submitted that under their contracts with the CNOOC the rights

of the foreign oil companies are not mining rights. Under Article 5 of the Petroleum Regulations 1982, "exclusive rights to explore for, develop, produce and market the petroleum within the zones of foreign cooperation" belong to the CNOOC. The foreign oil companies, in carrying out exploration and exploitation, are not assignees of the CNOOC's mining rights but, rather, "contractors" carrying out exploration and exploitation on behalf of the holder of the mining right, *i.e.* the CNOOC.

If the rights of the foreign oil companies are mining rights they should have ownership of the petroleum once they have reduced it to possession at the well-head. But such is not the case. The oil at the well-head belongs to the CNOOC and ownership of a foreign oil company's share of oil only passes to them at the outlet flange of the marine terminal or other storage facility for loading into tankers or other transportation equipment.

If the bundle of rights of a foreign oil company under the petroleum contract with the CNOOC is not a mining right (it is submitted that this is the correct view), then unless there is a contractual provision in the petroleum contract prohibiting the mortgage of a foreign contractor's interest in the petroleum contract, such an incorporeal moveable is mortgageable. There is no prohibition in the Model Contract²⁴ against assignment by the foreign contractors of their interests in the petroleum contract. The CNOOC cannot legally assign the mining rights granted to it by the State under Article 5 of the 1982 Petroleum Regulations, but it could assign its interests in the petroleum contract to its lenders.

(3) State-owned property

Property of a state enterprise which does not fall within the category of property that cannot be mortgaged, as mentioned above, may still not be mortgageable under Chinese law if it is caught by paragraph 113 of the Opinion on the Civil Law. Paragraph 113 provides:

The mortgage of any property over which the mortgagor does not possess exclusive rights or does not have enterprise management rights is void.

Article 2 of the Law of Industrial Enterprises Owned by the Whole People (hereinafter 'State Enterprise Law')²⁵ provides:

²⁴ So far, three sets of the petroleum "Model Contract" have been promulgated, one for each of the three bidding rounds for petroleum contracts between the foreign oil companies and the CNOOC.

²⁵ It came into force in August 1988.

Property in enterprises shall be owned by the whole people. In accordance with the principle of separating ownership from management the state grants to the state enterprises the right to engage in business activities relating to their property and to manage their property.

These "enterprise management rights" with regard to the property owned by the state include the "right to possess, use and dispose of, according to the law, the property given to them by the State to operate and manage."²⁶ The right to dispose includes the right to "lease or assign for value, in accordance with stipulations of the State Council, fixed assets given to them by the State to operate and manage."²⁷

There is no clear provision in the State Enterprise Law that the "enterprise management rights" include the right to mortgage the enterprise's property. It seems that no notice had been taken of the preceding Opinion on the Civil Law.²⁸ This lack of close scrutiny of other related statutes to ensure that the different laws and regulations promulgated form a cohesive whole, is not unusual in Chinese legislation.

2. Legal nature of a mortgage under Chinese law

Under Chinese law, a mortgage gives to the mortgagee a right to dispose of the mortgaged property when the mortgagor fails to repay the mortgage loan. This basic feature of a Chinese mortgage is stated, with different phraseology, in Article 22 of the Regulations of Shenzhen on Control of Secured Loans 1986, Article 39 of the Measures of Shanghai Municipality on Paid Transfer of the Right of Use of Land 1987 and paragraph 117 of the Supreme People's Court's Opinion on the General Principles of Civil Law. There is no detailed definition of the nature of a mortgage in the existing legislation.

An idiosyncrasy of modern Chinese law, if one may call it, is that a new practice sometimes precedes the law which subsequently affirms

²⁶ State Enterprise Law, Article 2.

²⁷ Article 29 of the State Enterprise Law. The right to lease and assign for value is subject to the proviso that "benefits derived from such assets must be used for renewing equipment or improving technology." It is submitted that failure to comply with this proviso would not affect the rights of the lessee but would subject the state enterprise concerned to being disciplined.

²⁸ The State Enterprise Law was passed on the 13th April 1988 by the National People's Congress and the Opinion on the Civil Law was adopted by the Judicial Committee of the Supreme People's Court on 26 January 1988.

the practice. For example, 'wholly foreign-owned enterprises'²⁹ had been in existence for about six years before the "Wholly Foreign-Owned Enterprises Law" was promulgated. This law mainly codifies what had been the practice before the law was promulgated to give such a type of foreign investment a legal basis. In the absence of detailed information on the legal nature of a mortgage in the existing legislation, one may turn to existing practice for guidelines.

The Bank of China, the most prestigious state Bank in China, produced in 1986, a treatise for internal use, entitled "Long Term Loans From the Bank of China to Sino-Foreign Joint Ventures".³⁰ The writer of the treatise defined a mortgage as a form of debt guarantee whereby the debtor at the time of assuming the responsibility of the debt gives to the creditor the right to possess and control the mortgaged property, retaining for itself only the right to use the property. He goes on to explain that following the grant of the mortgage the mortgagor continues to have the right to use the property in his own name since he still owns the right to use the property. If the mortgagor commits a serious breach of the mortgage contract or is unable to repay the debt, then the creditor has the right to auction the mortgaged property to pay the debt.

3. *Second mortgage*

Paragraph 114 prohibits second mortgages secured on an asset without the consent of the mortgagee:

If the mortgagor retains possession and custody of the mortgaged property and while the mortgage is still in force the mortgagor, without the consent of the mortgagee assigns the mortgage to another person or using the price value of the mortgaged property arranges a mortgage of a portion of the value, then the mortgage is void.

Provided the mortgagee gives its consent, a second mortgage is valid. There is no protection here for the mortgagor against unreasonable withholding of consent by the mortgagee. The advantage of the second mortgage is that it enables the borrower to obtain further secured credit, making maximum use of his assets. However, in international financing of petroleum projects, a second mortgage is not normally used to secure the project assets. A second mortgage is of use to China's state-owned

²⁹ A 'wholly foreign-owned enterprise' is an enterprise incorporated in China, with only foreign capital.

³⁰ A copy of this treatise in Chinese can be found in the appendix to Cheah Pei Chi, *Reforms in Debt Financing in the PRC*, LL.M. dissertation, Hong Kong University.

oil corporation in obtaining further credit secured on their general corporate assets, *e.g.* office buildings.

The final part of paragraph 115 deals with the ranking of the priority of competing mortgages. The mortgages are to rank in priority according to the order of the grant of the mortgages.

4. *Rights of a mortgagee*

Legislation applicable nationwide is silent on the following legal issues:

1. whether the mortgaged property can be forfeited in which case, if there is an appreciation in the value of the mortgaged property, then the lender would have made a profit;
2. whether the mortgagee can take possession of the mortgaged property and receive the income generated to pay off the debt or whether, instead, the mortgaged property has to be sold off, *i.e.* can the mortgagee act as, or appoint, a receiver?; and
3. can the sale be private or has it to be by way of public auction; a requirement of sale by auction is based on the presumption that an auction fetches the best possible price available.

Answers to these issues are found in local legislation which only apply locally and will not be discussed in this article.

(1) Forfeiture of mortgaged property

Although there is no express prohibition against forfeiture of the mortgaged property by the mortgagee, the implication of the Enterprise Bankruptcy Law, which applies to state enterprises only, is that forfeiture is not allowed. Article 27(3) of the Law states:

Property put up as a security does not belong to the bankruptcy property.³¹ Where the value of the property put up as security exceeds the amount of the debt for which it is put up, the excess portion shall belong to the bankruptcy property.

³¹ The "bankruptcy property" is said to consist of:

1. All the property managed and administered by the bankrupt enterprise when the declaration of bankruptcy is made.
2. The property acquired by the bankrupt enterprise during the period from the declaration of bankruptcy to the completion of the bankruptcy proceedings.
3. The right to other property that should be exercised by the bankrupt enterprise.

So the mortgagee, at least in a situation of bankruptcy, does not have the right to forfeit the mortgaged property but only the right to a share of the proceeds of sale of the secured assets in priority to the unsecured creditors.

(2) Restriction on transferability

The final part of paragraph 113 of the Opinion on the Civil Law deals with the mortgages of products which are subject to state control over its sale. Paragraph 113 provides as follows:

If the mortgaged property is subject to legal control over its transferability then at the time of the enforcement of the mortgage, the mortgaged property shall be sold to the relevant department. The mortgagee will enjoy priority in repayment from the proceeds of sale of the mortgaged objects.

It has been a long established state practice, before the introduction of the economic reform, that the oil recovered in the PRC must be sold to Sinopec or Sinochem. I understand that if the oil produced by a Sino-foreign cooperative joint venture which belongs to the CNOOC is to be sold directly abroad without going through Sinopec, then the permission of the State Council has to be sought. Thus it would seem that the petroleum produced by a defaulting borrower would fall within the above provision that the lender is not free to dispose of the attached oil itself but has only a right to a share in the proceeds of sale.

The provision in paragraph 113 has the following detrimental effect for secured lenders. The oil belonging to a state-owned oil enterprise is sold to the state at controlled prices below the prevailing international oil prices. So the proceeds of sale are less than they otherwise would have been if not for the deflated prices offered by the state. In other words, if the secured lenders are free to sell the attached oil in the international markets they would be able to sell the oil at the higher international price. So some form of protection for the lender with regard to this may need to be negotiated, for example, an appropriately worded minimum price guarantee for the price of crude oil sold to the state as required by paragraph 113.

5. *Registration of mortgages*

At present, there is no national system of registration of mortgages. But in Shenzhen and Shanghai,³² local legislation on mortgages requires

³² See Articles 35 and 40 of the Measures of Shanghai Municipality on Paid Transfer of the Right of Use of Land.

registration. Both these pieces of local legislation are, however, silent on the legal consequences if the mortgage is not registered, leaving unanswered the question as to whether the unregistered mortgage is void or merely unenforceable until duly registered.

6. *Mortgage has to be evidenced in writing*

Paragraph 112 of the Opinion on the Civil Law sets down the following requirement:

When the debtor or a third party grants a mortgage to the creditor, it should be evidenced by a written contract or the mortgage should be recorded in the original loan contract. Where there is no written contract, but proof identifying the property being mortgaged or documents of title have been handed over to the mortgagee then that would be recognised as proof that a mortgage has been granted.

Thus a mere oral grant of a mortgage without constructive (symbolic) possession of the mortgaged property, for example, possession of documents of title, is not sufficient.

At the same time, where there is a written mortgage contract either as a separate document or as part of the loan agreement then possession (actual or constructive) of the mortgaged chattel is not necessary. Many legal systems, for example, the Scottish legal system, generally require possession of the mortgaged chattel by the mortgagee or its agent to prevent a "secret mortgage".³³ This requirement can in many cases hinder the smooth conduct of the borrower's business, a difficulty which the Chinese approach has avoided.

B. *Assignment*

In the PRC, mortgages are utilised over not only land but also chattels. Where a security interest is attached to contract, the term (often but not always) used is "*zhuan rang*", translated as "assignment", instead of the term "*diya*", translated as "mortgage".

There is no legal definition of the nature of an assignment in Chinese law under the existing legislation. The references to "assignment" found in Article 91 of the General Principles of Civil Law and Articles 26 as well as 27 of the Foreign Economic Contract Law deal only with the conditions that have to be satisfied to effect an assignment under Chinese law.

An indication of the scope of the term "assignment" is found in the model assignment clause worked out between the MOFERT and the

³³ See Ian Inglis, "Financing and Security in Scots Law", Occasional Paper No. 2, Centre for Petroleum and Mineral Law Studies, University of Dundee, at p.7.

U.S.-based Overseas Private Investment Corporation for the guidance of approval authorities in China, which states:

No assignment (including by sale, transfer, mortgage, gift or other disposition) of all or part of either party's interest in the company shall be made without the consent of the other party and the approval of the Examination and Approval Authority.

Here the term "assignment" has a very wide meaning, referring to any form of transfer of an incorporeal asset, in this case an interest in the insured company.

A good explanation of the nature of an assignment by way of security is found in the internal treatise of the Bank of China treatise, mentioned earlier.³⁴ In the treatise, it is said that an assignment is a transfer by one party of its contractual rights or a transfer of both its contractual rights and obligations under the contract to a third party. In the case where a party assigns its contractual rights and obligations it cannot relieve itself of its obligations under the contract because of the assignment. In other words, the assignor remains primarily responsible for the performance if the assignee defaults.

1. *Need to obtain consent*

The assignment of a contract is subject to the consent of the other party to the contract and also the approval of the original approving authority. Under the petroleum Model Contract an assignment of the foreign contractor's interest in the petroleum contract requires the approval of the CNOOC, but the CNOOC may assign its interest under the petroleum contract to a third party controlled by the Chinese government without the consent or approval of the foreign party to the petroleum contract. CNOOC only needs to obtain the written consent of the Government of the PRC.

In the Foreign Economic Contract Law, the exception to the need for approval from the original approving authority is "unless otherwise stipulated in the approved contract". In the General Principles of Civil Law, the exception is "unless otherwise specified by the law or in the contract". The problem with this need for approval from the original approving authority has been the refusal of the MOFERT to approve any clause in a joint venture contract whereby the Chinese joint venture partner gives its consent in advance to an absolute assignment, *in the future*, of the foreign partner's rights under a joint venture contract upon the happening of certain event or events. Without consent from the MOFERT, the lender might find that when the event of default actually occurs the consent needed may not be given at all or that there would be a long delay in the consent being granted.

³⁴ See *ante*, subsection V.A. (2).

The MOFERT has recently softened its position. In 1989, the MOFERT and the U.S.-based Overseas Private Investment Corporation (OPIC) worked out a model clause to be incorporated into a Sino-foreign joint venture contract where the foreign partner is insured by the OPIC. Under its insurance policy the OPIC requires the insured enterprise to assign up to 90% of its interests in the insured investment to it when the latter is required to make an insurance payment to the insured enterprise.

It has been agreed between the MOFERT and the OPIC that the following clause whereby the Chinese partner to a Sino-foreign joint venture gives consent to the future assignment of the interest of the insured foreign partner shall be approved by the local Chinese approval authorities:

No assignment (including by sale, assignment, pledge, gift or other disposition) of all or part of either party's interest in the company shall be made without the consent of the other party and the approval of the Examination and Approving Authority. When a party wishes to transfer all or any part of its interest in the company, the other party shall have a right of first refusal or purchase, as stipulated in the Articles of Association or the provisions of this contract.

Notwithstanding the foregoing provisions, the parties agree that Party B (foreign party) may transfer its interest in the company to the Overseas Private Investment Corporation (OPIC) upon payment of compensation to Party B (foreign party) by OPIC under insurance pursuant to the Investment Guarantee Agreement of the Governments of China and the United States. After such transfer, OPIC shall assume all the corresponding obligations and responsibilities of Party B as stipulated in the contract.

2. Method of assignment adopted by Bank of China

In the internal treatise mentioned above, it is disclosed that the Bank of China in granting a loan to a Sino-foreign joint venture normally requires as a condition precedent that the joint venture assigns to it its contractual rights but not the obligations under the joint venture contract. After the contractual rights have been assigned, the Bank will authorise the joint venture to use its own name to continue to act as a party to the assigned contract in carrying out the obligations under the joint venture contract and enjoy the rights and benefits arising from it. When the borrower acts in breach of the loan contract this authority automatically becomes void. Presumably, in such a situation the mortgagee would take over the rights and benefits under the joint venture contract, leaving the borrower to perform the obligations. This practice of the Bank of China seems to avoid the problem encountered by lenders which take a security interest in an incorporeal asset created under Chinese

law by entering into a contract to assign the incorporeal asset to the lenders absolutely only when an event constituting default occurs.

In fact, this approach to the assignment by way of security of an incorporeal moveable, is similar in substance to that used in the assignment of an interest in a petroleum licence or joint operating agreement in the British sector of the North Sea. In such an assignment, the borrower (the assignor) remains liable to perform all the obligations assumed in respect of his interest in the production licence and the operating agreement and the assignee is not entitled to enforce the security by taking possession of the borrower's interest in the production licence or operating agreement until an event constituting default has occurred.

At this stage of the development of China's security law, it is not possible to say whether the assignee who did not take possession of the rights in the assigned asset may be defeated by a subsequent assignee who takes possession of the assigned asset. The lender who does not take possession of the assigned assets immediately may protect its interest by making the grant of a further assignment in the secured incorporeal moveable an event constituting default in the loan contract. The fact that an assignment of an interest in a petroleum contract needs the approval of the MOFERT would serve as a form of protection for the lender against further assignment of the secured asset by the borrower.³⁵

Another form of protection for a lender would be the negative pledge clause normally incorporated into a loan contract. This clause restricts the borrower's right to grant security in favour of other creditors. The negative pledge in an international loan contract is often reinforced with a restriction on leasing as a lease has the same economic and commercial effect as a security.

3. *Protection for the lender*

To ensure that Article 26 of the FECL is complied with by its borrower, a lender should adopt a practice such as requiring the borrower to give written notice to the other party to the secured contract of the assignment of the borrower's interest in the secured contract and the latter being required to send a letter of acknowledgment to the lender acknowledging recognition of the assignment.

How can a syndicate of foreign banks lending money to China's petroleum industry ensure that the borrower in China does not amend, change or terminate the contract assigned by way of security? One method is by making the bank acting as agent to the syndicate of lenders

³⁵ Article 27 provides that the approval of the original approving authority is required for an assignment of the approved contract unless "otherwise stipulated in the approved contract". As far as I am aware, such an exemption is not incorporated into a petroleum contract approved by the MOFERT.

a party to all important contracts for the petroleum project so that no effective changes, amendments to or termination of the assigned contract can be made without the Agent bank's consent. However, because this arrangement would render the agent liable were a breach of the contract to occur, an indemnity clause should be incorporated in the loan contract to indemnify the agent for any damages it has to pay arising from any breach in the contract to which it is a party.

VI. CONCLUSION

From the preceding discussion, it can be seen that the taking of security over assets in China is fraught with difficulties because of the undeveloped state of the Chinese law which is inadequate to deal with the complexities of international financing. The difficulties cannot be resolved simply by using a foreign system of law to govern the contract. Thus at present, protection for international commercial banks which are providing finance for petroleum projects in China is in the form of a guarantee to repay the loan if the borrower fails to do so.

Where the security law of China does not have an answer to an important legal issue, the parties to the loan agreement or security agreement can fill that gap by contractual provisions. However, there are limits to the parties' freedom to contract. Article 4 of the FECL provides that the foreign economic contracts "should not be prejudicial to the public interests of the society of the People's Republic of China." Also, in drafting those terms the parties need to have regard to the State's attitude towards mortgage transactions, otherwise the contract when submitted for approval by the MOFERT may be rejected. If the contractual provisions touch on issues involving foreign exchange they have also to meet the approval of the State Administration of Exchange Control.

Ho MIEW SIN*

* LL.B. (Ext.) (Lond.), Diploma in Petroleum Law, LL.M, Ph. D. (Dundee).