



## Investment in Non-performing Loans in China

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### **I. Overview of the legal regime applicable to China's Non-performing Loan ("NPL")**

China's NPL market as well as the legal regime applicable to NPLs have developed rapidly over the past years, and has attracted attention from both international and local investors. Overall, China has steadily deregulated the trading of NPLs since the launch of this industry nearly two decades ago. This article introduces the history of China's NPL market and some important changes to the legal regime applicable to NPLs.

#### **a. Role of national level "Big Four AMCs"**

In 1999, four national level asset management companies ("AMCs"), i.e., Huarong, Great Wall, Orient, Cinda (collectively, the "Big Four AMCs") were established by the Chinese government to absorb the NPLs worth approximately USD 500 billion from China's four major state-owned commercial banks (primarily to facilitate the listing of such banks). At the time of establishment, each AMC was responsible for accepting, managing and disposing the NPLs from one of China's big four state-owned banks, i.e. the Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank, as well as the NPLs from China Development Bank.

In 2004, the Big Four AMCs were permitted to make additional investments in foreclosed assets, offer custodian and agency services, and acquire distressed assets in a market-oriented manner.<sup>1</sup> This marked the beginning of a transition towards market-oriented diversified financial business operations of the Big Four AMCs. Since 2010, the Big Four AMCs have become fully marketized by acquiring NPLs through market-driven mechanisms such as biddings and auctions. By 2016, all Big Four AMCs completed the joint-stock reform. Their business scope now allows them to invest in NPLs of banks, non-bank financial institutions and non-financial institutions, and they have been the dominating buyers of NPLs in China.

#### **b. Role of provincial level AMCs**

In 2012, AMC at the provincial level was allowed to be established by the Ministry of

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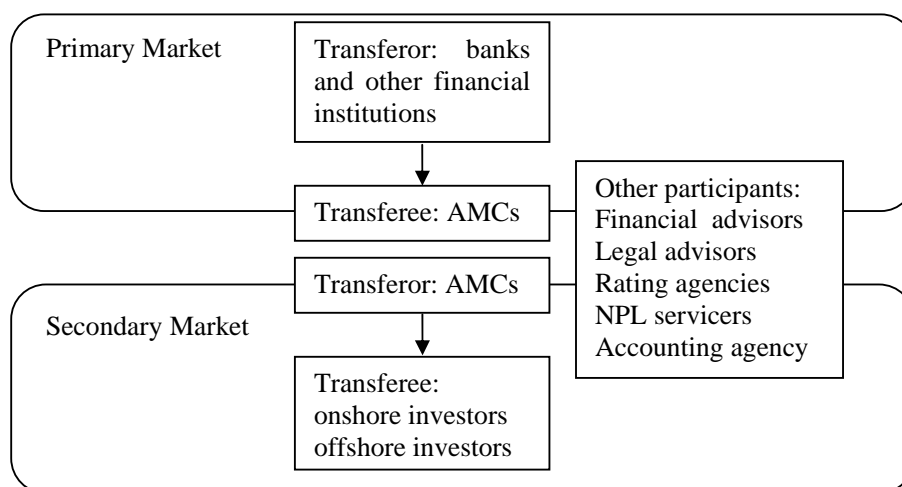
<sup>1</sup> See Administrative Measures for Relevant Business Risks of Financial Asset Management Companies(Cai Jin [2004] No.40) 《金融资产管理公司有关业务风险管理办法》(财金[2004]40号).

Finance ("MoF") and China Banking Regulatory Commission ("CBRC").<sup>2</sup> In 2012, each provincial government was allowed to establish one local AMC to participate in the bulk acquisition and disposal of NPLs from financial institutions within its own province, with the disposal method being limited to debt restructuring. Since 2016, the central government has introduced a series of supportive policies,<sup>3</sup> permitting each provincial government to establish one more local AMC, and allowing the local AMCs to dispose NPLs by, among other methods, transferring the NPLs to other investors without being subject to geographic limitation (including offshore investors).

The provincial level AMCs are still limited in certain aspects compared to the Big Four AMCs. For example, the Big Four AMCs may set up joint ventures with foreign investors, while it is unclear whether provincial level AMCs may do the same.<sup>4</sup>

## II. Transfer of NPLs

China's NPL market can be classified into the primary market and secondary market, with the key players in these two markets as follows:



In the primary market, banks and other financial institutions transfer their NPLs to AMCs, and AMCs then dispose the NPLs via multiple means, one of which is to transfer the NPLs in the secondary market to other investors (including both onshore investors and offshore investors). The transfer process is subject to a diverse set of laws and regulations in China, and special approval requirements apply in the case of the transfer to offshore investors.

### a. General process

In the primary market, banks and other financial institutions may transfer NPLs in batches to AMCs.<sup>5</sup> The bank should determine the scope of NPLs and carry out due diligence on the NPLs first. Based on the due diligence, the bank should evaluate the

<sup>2</sup> See Administrative Measures for the Bulk Transfer of Financial Enterprises' Non-performing Assets (Cai Jin [2012] No.6) 《金融企业不良资产批量转让管理办法》(财金[2012]6号).

<sup>3</sup> See the Circular on Properly Adjusting Relevant Policies of Local Asset Management Companies by CBRC (Yin Jian Ban Bian Han [2016] No.1738) 《中国银行监督管理委员会办公厅关于适当调整地方资产管理公司有关政策的函》(银监办便函[2016]1738号).

<sup>4</sup> The provincial level AMCs were first approved in 2012; but the relevant laws and rules regulating the joint venture set up by AMCs were promulgated before 2012, therefore it is unclear whether these laws and rules apply to provincial AMCs.

<sup>5</sup> *Id.* at 1.

NPLs and form the transfer plan. After the transfer plan is reviewed and approved internally, a transferor will invite interested AMC's to conduct due diligence on the target NPLs.

The transfer must be conducted via competitive means (such as bidding and auction) in order to maximize the sale proceeds. The winning bidder will enter into an NPLs transfer agreement with the transferor. Both parties should, within the agreed period, issue public announcement to inform the debtors and the guarantors of the NPLs regarding the occurrence of the transfer.

To transfer NPLs in the secondary market, an AMC is required to disclose the basic information of the target NPLs on its public websites as well as a designated newspaper. In particular, for any disposal of NPLs whose book value is more than RMB 10 million but not more than RMB 50 million, an announcement must be made in a newspaper at municipal level or above. For any disposal of NPLs whose book value is more than RMB 50 million, an announcement shall be made in a newspaper at provincial level or above.<sup>6</sup> Announcement period should generally last for at least 10 working days to 20 working days.

The transfer process in the secondary market should also be carried out by competitive means, including but not limited to bidding, auction, invitation to offer and public inquiry/solicitation. Without the public competition process, AMC's may not transfer NPLs to non-state owned transferees. The relevant AMC and the winning bidder should enter into NPLs transfer agreement after the process is concluded. The AMC may issue public announcement regarding the transfer and notify the debtors to repay outstanding debts to the relevant transferee.

b. Special process for transferring NPLs to offshore investors

Transfer of NPLs to an offshore investor is subject to administration by the National Development and Reform Committee ("NDRC") and the State Administration of Foreign Exchange ("SAFE"). We understand from the past Chinese practice that the NDRC only accepts filing of the NPLs transfer from onshore AMC's to offshore investors and does not grant the approval to NPLs transfer from an onshore bank to an offshore investors. However, on 1 June 2017, SAFE Shenzhen Branch was granted the authority to examine and approve the pilot cross-border transfer of NPLs by domestic banks on a case-by case basis.<sup>7</sup> Nevertheless, as a matter of practice, transfer of NPLs in batch of more than 3 units by banks still need to be proceeded through AMC's.

In accordance with relevant regulations and rules, after a winning offshore bidder has executed the NPLs transfer agreement with the selling AMC, the following additional steps should be taken in connection with the transfer of NPLs:

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<sup>6</sup> Also note that AMC's must not transfer the following NPLs to buyers other than government authorities and state-owned buyers: where the debtor or guarantor is a government authority; where the debtor is a state-owned enterprise subject to national policy-based bankruptcy plan as approved by the State Council; where the creditor's rights concern national security and sensitive information, i.e., creditor's right involving military or national defence industries; other creditor's rights the transfer of which is restricted by laws and regulations. As a matter of practice, AMC's will first confirm with the relevant regulatory authorities (such as CBRC) regarding any restrictions on the proposed transferee of the target NPLs, and will specify such restrictions in the disposal public announcement.

<sup>7</sup> See the Approving Reply to Shenzhen Branch on Developing Pilot Cross-border Transfer of Non-performing Assets Business in its Administered Banks (Huifu [2017] No. 24) 《关于深圳市分局开展辖区内银行不良资产跨境转让试点业务有关事项的批复》(汇复[2017]24 号) issued by SAFE on June 1, 2017. This reply shall be valid for one year from the date of the reply.

- Registration with NDRC by the AMC.<sup>8</sup> The AMC is required to file with the NDRC for the transfer of NPLs by submitting: (i) information on the NPLs (book value of principal, gross interest, main composition, geographical coverage, and third-party evaluation); (ii) transfer agreement; (iii) disposal announcement released on news media; (iv) certificate of incorporation, relevant commitment in writing, and proof of credit and business performance of offshore investor; (v) notarial certificates issued by the notary authority for the transfer process (brief introduction of the NPLs, the transfer method, main onshore and offshore investors involved in the transfer, and relevant quotation); (vi) legal opinions issued by the law firm representing the AMC. The NDRC is required to decide whether to accept the filing within 5 business days after receipt of the application material, and issue a registration certificate within 7 business days after the acceptance.
- Registration with local SAFE. After completing the filing with the NDRC, depending on local practice, the AMC may need to complete foreign exchange registration with SAFE in order for the AMC to convert foreign exchange consideration for selling the NPLs into RMB (in some localities, SAFE has delegate such authority to commercial banks and the AMCs can process the currency conversion with banks directly).<sup>9</sup> Further, if any cross-border security should arise from the cross-border transfer of NPLs, it should be administrated by relevant rules of cross-border guarantee by SAFE.<sup>10</sup>
- Foreign exchange settlement by the AMC with bank. The AMC may, upon the receipt of the consideration for selling the NPLs to an offshore investor, directly process the accounting and settlement of the foreign exchange consideration with its bank by submitting: (i) an application letter; (ii) the registration certificate; (iii) a photocopy of the key provisions of the NPLs transfer agreement; (iv) other supplementary documents.
- Foreign exchange remittance by the offshore investor with bank. The offshore investor may remit abroad its income<sup>11</sup> from recovery or re-transfer of the NPLs by submitting to the bank: (i) an application letter; (ii) the registration certificate, (iii) a photocopy of the key provisions of the NPLs transfer agreement; (iv) power of attorney (where applicable); (v) other supplementary documents.

### III. Collection and Recovery of NPLs

Like many other jurisdictions, enforcement of creditors' rights in China could be a complicated and time-consuming process. Below is a brief introduction of legal proceedings (litigation and non-litigation) applicable to the enforcement of debt in China, as well as an overview of general enforcement procedures and the treatment of various types of collateral.

<sup>8</sup> See Circular of the NDRC on Effectively Conducting the Reform of Foreign Debt Administration concerning Overseas Credit Assignment (Fa Gai Wai Zi [2016] No.1712) 《国家发展改革委关于做好对外转让债权外债管理改革有关工作的通知》(发改外资[2016]1712号).

<sup>9</sup> *Id.* at 8.

<sup>10</sup> See Notice of SAFE on Issues Concerning the Foreign Exchange Administration of the Disposal of Non-performing Assets by Financial Asset Management Companies to Foreign investors. (Hui Fa [2015] No.3) 《国家外汇管理局关于金融资产资产管理公司对外处置不良资产外汇管理有关问题的通知》(汇发[2015]3号).

<sup>11</sup> If the foreign investor has not set up organization or business place within China, or the income is not related to such organization or business place, the income will be subject to Chinese withholding tax at a rate of 10%.

a. Establishment of creditor's rights

Under Chinese law, a creditor may establish its rights against the debtor(s) through litigation proceedings or non-litigation proceedings.

1) *Litigation proceedings*

Litigation is commenced by filing the complaint with a court with competent jurisdiction. Normally, the court of first instance is the court in the jurisdiction where the debtor is located. To prevent the debtor from transferring his or her property, the creditor may apply for property reservation/seizing order either before or after filing the complaint. The hearing will be held at a time chosen by the court. The court usually holds only one formal hearing, but it may hold more as necessary (e.g., if the dispute is complicated). During the hearing, both parties can present evidence, cross-examine witnesses and debate the matters in dispute.

The length of the trial process varies from case to case within the time limit of 6 months for the first stance trial, and 3 months for appeals. The terms of the judgment handed down by a court will typically provide a grace period for performance, usually around 10 to 15 days. Once this period has expired, the party to whom judgment was awarded can apply to the court for enforcement. The application for enforcement shall be made within 2 years after the expiry of any performance period specified in the relevant judgment by a court (or, in case of the non-litigation proceedings, the performance period specified in arbitration award by arbitration tribunal, payment order or notarized enforcement certificate). Courts are legally required to enforce judgment within 6 months after receiving the application for enforcement. However, there are also broad exceptions to this rule and, in practice, enforcement can take years.

2) *Non-litigation proceedings*

In the interest of efficiency and cost, creditors may choose non-litigation methods, such as payment order and notarization of the loan agreement.

Payment order is a special legal proceeding available for disputes in connection with monetary or securities payment. Note, however, that the following conditions must also be met before an application for payment order can be accepted by the court: (i) the debt is due and the amount is definite and clearly supported by evidence; (ii) the lender has no outstanding liability to the borrower; and (iii) the payment order can be duly served to the borrower. If the borrower cannot be found, the court will not accept the application for payment order. The time limit for the court to issue the payment order is 15 days after the acceptance of the application. If the debtor does not file an objection in writing within 15 days after receipt of the payment order, nor repay the debt as requested, the enforcement proceedings can be initiated. However, if the debtor does file an objection within the above time period, the payment order would cease to be effective.

If the loan agreement is notarized by a public notary office after its execution with the debtor confirming its willingness to be subject to judicial compulsory enforcement upon its failure to repay the debt when due, then the creditor can apply to the court with competent jurisdiction for enforcement after the occurrence of the debtor's default based on the enforcement certificate issued by the public notary, without going through a court trial process. In practice, notarization of the loan agreement is widely adopted by commercial banks.

## b. Enforcement

Where a debt is secured by collateral, Chinese law prohibits the parties to a mortgage or pledge agreement from agreeing in advance that the title to collateral will automatically, upon the debtor's default, be transferred to the creditor who holds the security interest. However, the parties may freely agree to settle the outstanding debts after the occurrence of an event of default by transferring the title to collateral.

If the parties cannot reach a settlement agreement, the creditor may enforce against the collateral by requesting the court with competent jurisdiction to put the collateral up for auction. The court is required to engage a commercial auction agency to carry out the auction and to pay such agency's fees from the auction proceeds. In practice, courts usually give a floor price to the auction agency after consulting with the creditor.

All the interested parties (including the creditor) may participate in the auction and the highest bidder should win. Where all of the bids are lower than the floor price during a given round of an auction and the creditor refuses to accept the property to settle the debtor's debt, the auction is deemed to have failed. In such case, the court may hold another round of the auction within 60 days (in which the floor price may be lower subject to agreement by the creditor). Generally, personal property cannot be subject to more than two rounds of auctions, while real property and other property rights may not be subject to more than three rounds of actions. If the collateral is successfully sold by auction, the proceeds are paid in the court, and the creditor will have a priority claim to the auction proceeds. The remaining proceeds will be returned to the debtor.

Normally, the property subject to enforcement (excluding gold, silver and products made thereof, personal properties whose market price is available, perishable articles, seasonal goods, and other articles which are difficult to preserve or need extremely high preservation expenses) must be sold through auction. But if the auctions fail for three times, the Enforcement Court can decide to sell off the property subject to enforcement to the creditor. As a matter of course, selling-off price could be lower than auction price. If the creditor does not agree to offset the debt by accepting the collateral, such collateral shall be returned to the owner of the collateral.

We set forth below the rules for creation and enforcement of security interests on major types of collaterals:

### *1) Real Property*

The general rule under Chinese law is that the building and land on which the building stands should be transferred together. Therefore, when a building is mortgaged to secure debt, the land underneath should be mortgaged too. When default occurs and the court enforcement procedure begins, the enforcement court can seal up the building and the land use rights. The enforcement court may do so by attaching a strip of sealing, making an announcement when sealing, or preserving relevant title certificates, if necessary. Where the debtor still fails to perform its duties under the loan agreement after the seal-up, such real property can be auctioned or sold off in enforcement proceedings, and the creditor will be entitled to proceeds equivalent to the amount of the outstanding debt.

Normally, the title to real property transfers when the title registration is updated. But if the real property is auctioned, its title transfers to the winning bidder when the enforcement court delivers the ruling on auction to the same. Note that the right of a

court to auction or sell off real estate in satisfaction of a judgment is subject to some restrictions. For example, if real property is essential to the living of a debtor, it may be sealed up, but it may not be auctioned or sold off to satisfy a creditor's claim.

Chinese law allows the mortgage of the completed part of the construction-in-progress and the underlying land. The owner of the construction-in-progress must have achieved the land use right certificate, the construction land zoning certificate and the construction project planning certificate. The mortgage is created upon the registration with relevant land and housing administration authority. It is worth noting that the security interest of the mortgagee is subject to construction contractor's right to construction costs. If the owner of the construction-in-progress defaults on construction costs, the contractor has the right to apply to the court for auction of the construction-in-progress and shall have priority in the auction proceeds.

## *2) Personal Property*

In addition to being sealed-up, personal property can also be detained and frozen. Along these lines, the court can take possession of such personal property or assign a third party to do so. In the case of a bank account of a debtor, the court can freeze the account. Personal property cannot be sealed or detained for a period of more than one year. A bank account cannot be frozen for a period of more than six months. For certain personal property whose title is subject to registration, such as motor vehicles, vessels, and aircraft, the applicable property registration authority shall be notified of the seal-up ruling.

If the personal property is sold in auction, the title transfer occurs when it is delivered to the winning bidder. Same as the enforcement of real property, the necessities that provide life support to the debtor (such as necessary clothing, cooking utensil, furniture, dining utensils or living expenses equal the minimum living standards) are exempted from the abovementioned enforcement measures.

## *3) Intellectual Property*

Although pledges over intellectual property have been allowed since 1995, they were rarely used in practice until recently. The increase in pledges of intellectual property is in part due to the issuance of a series of regulations by central and local governments on the creation, perfection and foreclosure of pledges over various types of intellectual property rights. Only the registered intellectual property which is assignable can be used as collateral. According to the PRC Property Law, pledge over intellectual properties is created when the pledge agreement is registered with applicable intellectual property authorities. In China, the registration authorities of trademark, patent and copyright is the State Trademark Office, the State Intellectual Property Office, and the Copyright Protection Center of China, respectively.

So far there has been no national law regulating the enforcement of pledge over the intellectual property. But some localities have made relatively general regulation in this regard. Local rules of Chongqing Municipality and Jiangsu Province, for instance, both provide that, upon the default of the debtor, the pledgee may exercise the pledge right by having the right to trademark sold or auctioned and the creditor is able to claim priority of compensation from the proceeds. Many details, however, like the procedures to "seize" the intellectual property, the coordination between the enforcement court and the relevant intellectual property registration authorities and the evaluation of the intellectual property concerned, are yet to be specified or clarified.

## IV. Debt-to-Equity Swap

Debt-to-equity swap is a resolution for creditors to deal with NPL issues. A creditor may convert its rights into the equity of the debtor, and then realize returns from a future sale of equity, trade sale, or other distributions from the debtor. In accordance with relevant laws and regulation in China, a debt-to-equity swap is allowed under one of the following circumstances:

- the creditor has already performed its contractual obligations and has not violated any laws, regulations, administrative decisions or the prohibitive provisions of the debtor's articles of association; or
- the proposed conversion has been approved by effective court judgments; or
- the proposed conversion through bankruptcy reorganization plans or settlement agreements has been approved by court.<sup>12</sup>

Both onshore investors and offshore investors are allowed to process the debt-to-equity swap by making the application to the Administration of Industry and Commerce ("AIC") having jurisdiction over the debtor. To address the growing NPLs problems faced by Chinese banks, in September 2016, Chinese government expressly encouraged commercial banks to carry out debt-to-equity conversion through the AMCs and other acquirers of NPLs.<sup>13</sup>

In addition, to complete the debt-to-equity swap process: (i) the creditor and the debtor should enter into a debt-to-equity swap agreement; (ii) the creditor's rights should be evaluated by an independent and qualified accounting firm or evaluation institution; (iii) the target company (debtor) should complete the registration with AIC for change of shareholders, capital increase and transformation of the company from domestic company to foreign-invested company (if the creditor is a foreign investor).<sup>14</sup>

## V. Prospect of China's NPL Market

Since the launch of China's NPL sector in 1999, the Chinese government has taken steps to gradually deregulate the sector with the objective of vitalizing and energizing the sector to attract more players (including foreign acquirers of NPLs). This trend has expedited in recent years. For example, in February 2016, eight Chinese ministries and commissions jointly released a document,<sup>15</sup> calling for, among other things, further improving efficiency in NPL disposals. We expect the Chinese government will take further measures in liberalizing the NPL market to address the ever-growing NPL pressure faced by banks in China. As a result, offshore investors may see more and more opportunities for them to participate in China's growing NPL market.

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<sup>12</sup>See Administrative Provisions on the Registration of the Registered Capital of Companies 《公司注册资本登记管理规定》 2014-02-20.

<sup>13</sup>See Guidelines on Market-Oriented Debt-to-Equity Swaps at Banks (Guo Fa [2016 No.54] 《关于市场化银行债权转股权的指导意见》 (国发[2016]54号).

<sup>14</sup>Through our most recent inquiries with several local AICs, we understand that the process for debt-to-equity swap would not be much more cumbersome for offshore investors than onshore investors.

<sup>15</sup>See Several Opinions on Financial Support to Maintain Steady Industrial Growth, Adjust Industrial Structure and Improve Industrial Efficiency (Yin Fa [2016] No.42) 《关于金融支持工业稳增长调结构增效益的若干意见》 (银发[2016]42号).





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Stewart Wang is a Partner in the Corporate team, based in DLA Piper's Shanghai office. As a corporate transactional lawyer, Stewart focuses on cross-border mergers & acquisitions, PE/VC, foreign direct investments, joint ventures, debt financings, employment matters and dispute resolution.

Stewart represents multinational companies and China-based clients across a wide range of industries including TMT, manufacturing, pharmaceutical, medical device, aerospace, and real estate sectors.

Stewart has mastered both local and international rules and practices, so as to add real value to his clients' business operations around the globe while helping them better manage their legal costs.

Stewart has also obtained his bar qualifications in China.

Recently, Stewart named to China Business Law Journal's 2016 A-List.

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## LANGUAGES SPOKEN

- Chinese (Mandarin)
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## EXPERIENCE

- Advising one of China's largest online food ordering and delivery platforms, in (i) its merger with Baidu Waimai, and (ii) its multiple billion financing from Alibaba
- Advising a Swiss institutional investor, in its private investment in Jupai Holdings Limited, a Chinese asset management company listed on the New York Stock Exchange
- Advising a major airlines in China in its strategic equity and business alliance with Delta Air Lines.
- Advising a leading Chinese car rental company listed on the New York Stock Exchange, in its private placement with certain US fund investors
- Advising a Jiangsu-based publisher, in connection with its US\$80 million entry into a definitive asset purchase agreement with Publication International Ltd. ("PIL"), an Illinois-based private company, and PIL's subsidiaries for Phoenix's acquisition of PIL's Children's book business
- Advising a Fortune 100 US company, in its multiple joint ventures with Chinese partners in aerospace sector
- Advising a Swedish security product company, in its acquisition of a number of well-known Chinese security door companies

## CREDENTIALS

### Professional Qualifications

- Attorney-at-law admitted with the Supreme Court of New York

## Education

- New York University, School of Law, LL.M., 2009
- University of Sheffield, LL.M: with Distinction, 2004
- East China University of Politics and Law, LL.B., 2003

## INSIGHTS

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### Publications

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12 DEC 2017

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## NEWS

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### DLA Piper advised China Eastern Airlines on investment in Air France-KLM

19 OCT 2017

DLA Piper has advised China Eastern Airlines (CEA), one of the largest Chinese airlines operating domestic, regional and international routes, on its strategic investment in Euronext Paris listed Air France-KLM.

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### DLA Piper advises China Eastern Airlines on investment in Air France-KLM

13 OCT 2017

DLA Piper has advised China Eastern Airlines (CEA), one of the largest Chinese airlines operating domestic, regional and international routes, on its strategic investment in Euronext Paris listed Air France-KLM (AFK). Through this transaction, CEA and SkyTeam alliance member Delta Air Lines (Delta) have each acquired a 10 percent stake in AFK's share capital within the framework of reserved capital increases. The transaction closed on 3 October 2017.

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### DLA Piper advises on the merger of Ele.me and Baidu Waimai

29 AUG 2017

DLA Piper has advised Ele.me, one of the largest food delivery service providers in China, on its merger with Baidu Waimai, another giant in the industry.

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### DLA Piper advises Avnet, Inc. on its acquisition of Dragon Innovation, Inc.

23 AUG 2017

DLA Piper represented Avnet, Inc. (NYSE: AVT), a global value-added distributor of electronic components, on its acquisition of Dragon Innovation, Inc.

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### DLA Piper advises China Eastern Airlines on the strengthening of its strategic partnership with Air France

28 JUL 2017

DLA Piper is advising China Eastern Airlines on a global joint venture between Air France KLM, Delta Airlines (Delta) and China Eastern Airlines (China Eastern), which have been consolidated by investments by China Eastern and Delta in Air France KLM.

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