



JONES DAY
COMMENTARY

CHINESE SUPREME COURT PROTECTS STATE-OWNED ASSETS IN LITIGATION RELATING TO NON-PERFORMING LOANS

China established its non-performing loan assets disposal market in connection with the reform of state-owned banks in 1999. Non-performing loans (“NPLs”) were transferred to designated state-owned assets management companies (“AMCs”), which packaged them for sale. Since then, various regulations and rules have been promulgated to regulate the disposal of NPLs, including regulations to permit foreign investors to participate in the restructuring and disposal of NPLs with AMCs.

Recently, the Supreme Court of China issued new guidance to the courts in connection with NPL-related litigation that may have an adverse impact on the sale and purchase of NPLs by investors as well as on the enforcement of their rights under NPLs.

SUPREME COURT ISSUES GUIDANCE ON NPL LITIGATION

On April 3, 2009, the Supreme Court of China issued the “Minutes of the Working Seminar by the Supreme People’s Court regarding Hearing Cases in Connection with Transfer of Financial Non-performing Creditor’s Rights” (the “Minutes”), followed by an explanation of the Minutes, “Several Political and Legal Questions regarding Trial of Financial Non-performing Creditor’s Rights—Explanations to the Minutes of Supreme People’s Court regarding Hearing Cases in Connection with Transfer of Financial Non-performing Creditor’s Rights” (the “Explanations”). Together, the Minutes and the Explanations introduce new measures that strengthen protection of

state-owned assets during NPL disposal. Although the Minutes and Explanations are not official judicial interpretations given by the Supreme Court and thus cannot be cited by the courts in rendering judgment, courts in various municipalities and provinces have interpreted the principles enunciated in the Minutes by reportedly suspending acceptance, trial, and enforcement of NPL-related cases that involve state-owned assets.

According to the Minutes, the Supreme Court, working with various central-level authorities (including the National People's Congress Standing Committee on Legislative Affairs, the Ministry of Finance, the State-Owned Assets Supervision and Administration Commission, China Banking Regulatory Commission, the People's Bank of China, and the State Audit Bureau), tried to come up with a solution to address various perceived shortcomings that have arisen in connection with the disposal of NPLs involving state-owned assets. Those shortcomings included the pricing of NPLs for disposal, collusion among certain bidders and the AMCs in the NPL bidding process, and inadequate notice to the debtors and guarantors that the NPLs have been transferred. The measures proposed by the Supreme Court do not necessarily reflect the consensus view among the various ministries but rather an attempt by the Supreme Court to seize the initiative on the various issues.

SCOPE OF SUPREME COURT GUIDANCE

It is important to note that the Minutes technically apply only to a limited set of NPLs spun off from state-owned banks prior to 2006. Specifically, the Minutes apply to:

- Policy-based NPLs acquired from the four state-owned AMCs (*i.e.*, Huarong, Greatwall, Orient, and Cinda) from Bank of China, Agricultural Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and China Development Bank from 1999 and 2000.
- Commercial NPLs acquired from the AMCs from Bank of Communications, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China from 2004 and 2005.

Nonetheless, until further guidance is given as to the policies, rules, and regulations that govern other NPLs involving state-owned assets, it is likely that local courts will follow the Minutes and Explanations in handling other NPL cases involving state-owned assets.

COURTS NOT TO ACCEPT CERTAIN CATEGORIES OF NPL LITIGATION

The Supreme Court has advised that local courts should not accept the following types of NPL related cases:

- Actions between AMCs and state-owned banks in connection with transfer agreements of policy-based NPLs.
- Actions against state-owned or state-controlled enterprises if the debtor is either on the list of enterprises to be reorganized or is in the midst of reorganization under the State Council's policy-based closure and bankruptcy proceeding.
- Actions by debtors or parties with right of first refusal to invalidate any NPL transfer if the debt has already been discharged prior to the issuance of the Minutes.
- Actions by purchasers of NPLs against state-owned banks for defects in the NPL after AMCs assign NPLs to such purchasers.
- Actions against forestry industrial enterprises that enjoy the benefit of natural forestry resources and protection plan policy.
- Actions by debtors or by parties with right of first refusal to invalidate any NPL transfer if such debtors fail to provide bond or if such parties had waived the right of first refusal.

Although this list of cases appears self-evident, and the NPLs involved are generally excluded from the list of NPLs packaged for resale to investors, anecdotal evidence suggests that local courts are refusing to accept a broader category of NPL cases.

INVALIDITY OF NPL TRANSFER AGREEMENT

The Minutes also establish that the sale and transfer of NPLs to a purchaser may be invalidated for a number of reasons, including:

- The debtor or guarantor of the NPL is a state organ.
- The NPL involves national security or sensitive information about national defense or the military industry, as determined by the applicable state organ, or if the transfer of such NPL is prohibited or restricted by law.
- The AMC maliciously colluded with the purchaser of the NPL.
- The NPL was transferred without public notice or in violation of the process and procedures established under the *Administration of the Asset Disposal Announcement of Financial Asset Management Companies (Revised)*¹ (“Administration of Asset Disposal Announcement”).
- Substantial inconsistencies exist between the overall NPL portfolio actually transferred and those disclosed in the public notice.
- The NPL portfolio is not appraised when such appraisal is required, or the AMC, appraisal organization, and/or the debtor maliciously collude to undervalue or omit the value of the NPL.
- A public bidding or auction of the NPL portfolio is not conducted even if required by laws or regulations, or less than three bidders participate in the public bidding process, or the public bidding is not conducted by a qualified auction intermediary, or such other violation of the requirements set forth in the PRC Auction Law.²
- Necessary approvals and registrations from the National Development and Reform Commission, the State Administration of Foreign Exchange, or such other applicable legal authority are not obtained.

- The NPL of a state-owned or state-controlled enterprise is transferred to a government official, financial supervision institution personnel, judicial or public security officer, AMC personnel, appraisal staff, or an executive or intermediary of the debtor such as its lawyer or accountant and any other connected person who participates in disposition of assets.
- The purchaser or holder of the NPL is an immediate family member of the AMC personnel participating in disposition of NPLs, the state-owned or state-controlled debtor, or the responsible person at the appraisal organization of the NPL.
- Any other situations involving national and public interest exist.

If a transfer of NPLs is invalidated by the court, the remedy is rescission and the purchase price returned; however, the transferee can sue for additional monetary damages based on the actual amount of interest accrued and paid by the transferee on the purchase price. According to the Minutes, any invalidation of a transfer of NPLs to any subsequent holder of such NPLs will also invalidate all prior transfers of the same NPL. As a result, any litigation involving NPL transfers will likely have to involve the AMCs and all prior and subsequent transferors and transferees of the NPL, which will increase the complexity and litigation costs, resulting in higher uncertainties to NPL investors.

To add further complexity to any action to invalidate the transfer of NPLs, the Minutes provide that where the invalidated NPL is part of a larger portfolio of NPL assets, the court may nevertheless invalidate the transfer of the entire portfolio if requested by the transferee. The court may also invalidate only the portion of the NPL portfolio whose debts have not been repaid or settled if requested by the transferee; however, in such circumstance, no restitution will be paid for the purchase price of the assets.

1. Promulgated by the Ministry of Finance and China Banking Regulatory Commission on July 11, 2008.

2. Adopted by the Standing Committee of the National People's Congress on July 5, 1996, revised by the Standing Committee of the National People's on August 28, 2004.

SUPREME COURT ESTABLISHES NEW RIGHT OF FIRST REFUSAL BY LOCAL GOVERNMENT TO NPLS

The Minutes also establish that local governments, their investment organs, and the related entities holding the state-owned enterprise's capital have the right of first refusal in purchasing NPLs transferred from AMCs. Establishing such right of first refusal to NPLs should properly be a function of, and administered by, the Ministry of Finance, which supervises the AMCs. However, the Supreme Court has used its power to accept cases and to revoke NPL transfers to establish this right of first refusal.

According to the Minutes, AMCs must notify such preemptive right holders of the proposed transfer of the debt obligations of such state-owned or state-controlled enterprise that are located at such debtor's place of registration. If the NPLs are bundled into a larger portfolio of assets composed of debtors primarily domiciled in the same administrative area, AMCs must notify the preemptive right holders within the same locality. If the NPLs are bundled into a diverse assets portfolio, the AMCs must notify the preemptive right holders in the locality where the largest amount of NPLs in value are based.

The preemptive right may be waived by writing or if no response is received pursuant to the notice given. However, no guidance was given as to how such notice is to be given, how much time must be provided, and other processes and procedures.

MISCELLANEOUS PROVISIONS

The Minutes also clarify certain other issues relating to the disposal and enforcement of NPLs. Among the highlights are the following:

Suing State-Owned Banks. Although the state-owned and state-controlled banks are generally exempt from litigation involving NPLs, the Minutes clarify that such state-owned banks may be sued for unjust enrichment in the following situations:

- If a debtor knows or should have known that its NPLs have been transferred but nonetheless continues to service its debts to the state-owned banks that originated the loan, such debtor must repay its debts to the purchaser of the NPLs and then sue the state-owned banks to recover the amount owed.
- If a debtor does not know that its NPLs have been transferred and services its debts to the state-owned banks that originated the loan, then the purchaser of the NPL cannot claim against the debtor but may instead sue the state-owned banks to recover the amount owed.

According to market practice, a standard clause in NPL transfer agreements is waiver by the purchaser of NPLs to sue the bank that originated the loans. Such clause is generally not negotiable and accepted by investors since there was legal uncertainty whether such lawsuits are even permitted. However, investors may wish to rethink their acceptance of this clause in light of the Minutes.

Revocation of NPL Transfer Agreement. The Minutes confirm that debtors are entitled to revoke any purported transfer of NPLs if it can be proved that either such NPLs do not exist or have been fully or partially discharged. In such an event, the purchaser of NPLs may claim against the AMCs for damages.

Whether Interest Can Be Claimed. Generally, in litigation between transferors and transferees of NPLs, the court will not uphold claims for interest accrued after the day of NPL transfer, except in circumstances in which the transfer of the NPLs is invalidated.

Choice of Forum. The Minutes confirm that choice of forum clauses negotiated between debtors and the AMCs are valid and will be enforced. This reduces a legal uncertainty that existed and should help to reduce litigation costs and uncertainties in debt recovery against local protectionism.

Change of Parties During Litigation or Enforcement. The Minutes emphasize that courts should replace the transferor with the transferee as the party to the litigation upon application by transferor or transferee. Although this requirement has appeared in previous interpretations by the Supreme Court, courts in practice continue to be inconsistent in its application.

CONCLUSION

The Chinese Supreme Court, through the issuance of the Minutes and the Explanations, has ventured into the legislative arena by introducing new measures, such as the right of first refusal to purchase NPLs, that are the function of other State organs. The Minutes emphasize protection of state-owned assets over contract law and other legal principles. Although the actual scope of the Minutes is circumscribed and the enumerated types of NPL cases that courts will not accept are limited, the practical effect has been a near cessation of new NPL cases being accepted. Even when such cases are accepted, courts are likely to give judgment based on policy concerns rather than the rule of law.

The Supreme Court acknowledges that the measures introduced in the Minutes are still a matter of debate among various ministries and State organs. Further circulars and rule-making at higher State levels may clarify the direction of the NPL market in China. Until that time, investors should proceed with caution when participating in the NPL market.

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