Bankruptcy Law Interpretation III and Potential Impact on Collateral Arrangements

Introduction

On 27 March 2019, the Supreme People’s Court (the “SPC”) published its Interpretation on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the People’s Republic of China (III) (the “Bankruptcy Law Interpretation III”) which became effective on 28 March 2019. The Bankruptcy Law Interpretation III clarified certain aspects of the PRC Enterprise Bankruptcy Law, with the ultimate goal of improving the business environment in China by strengthening creditors’ right and the rule of law surrounding corporate insolvencies.

Amongst other issues, the SPC clarified that the courts should uphold the priority of secured creditors over security granted by a Mainland Chinese company before the commencement of bankruptcy proceedings. This is an important clarification for both offshore and onshore creditors who take security from Mainland Chinese counterparties. With the implementation of regulatory margin requirements for non-centrally cleared derivatives in full swing globally, counterparties taking initial margin collateral from Mainland Chinese counterparties will surely welcome the clarification offered by the SPC.

Against this background, we will review in this Bulletin some of issues associated with collateral arrangements (both title transfer and security interest) with Mainland Chinese counterparties. To this end, we will limit our analysis to cross-border collateral arrangements (which are not governed by Chinese law) with security provider being a Mainland Chinese counterparty. We will also confine our analysis to offshore collateral located outside Mainland China.

Title transfer arrangements

Cross border “title transfer” arrangements are not uncommon with Mainland Chinese counterparties. Indeed, regulatory variation margin (“VM”) requirements (which came into force in 2017) have been implemented using title transfer collateral arrangements since VM is required to be provided on a two-way net basis. The standard documentation for VM was developed by the International Swaps and Derivatives Association (ISDA) on this basis. The efficacy of title transfer collateral arrangements relies on the enforceability of close-out netting against Chinese counterparties, which we have discussed in our previous client bulletins. 1

In addition, since the concept of full title transfer has not been tested in Chinese courts, one may have a residual question on whether a Chinese court may re-characterise a title transfer arrangement as a security interest (with the attendant restrictions that come with a security interest arrangement). With respect to title transfer arrangements governed by a foreign law and involving offshore collateral, it is unlikely that Chinese property law (including PRC Property Law2) will apply to determine the efficacy of such title transfer arrangements pursuant to Chinese conflict of laws rules. It is therefore unlikely that a Chinese court will apply Chinese property law to re-characterise such title transfer arrangements as security interests.

Security interest arrangements

Regulatory initial margin (“IM”) is required to be provided on a two-way gross basis with IM collateral being segregated from the proprietary assets of the collateral provider. Regulatory IM requirements therefore have to be implemented using security interest arrangements.

Generally speaking, the proprietary aspects of a security arrangement are governed by the law of the place where the asset is situated (lex situs). In the context of a Mainland Chinese counterparty providing offshore collateral as security to a foreign counterparty, it is unlikely that the security arrangement will be governed by Chinese law.

Chinese law becomes relevant when the Mainland Chinese counterparty goes bankrupt. Chinese bankruptcy law provides for a stay on enforcement actions over the bankruptcy estate of the debtor during the period from the acceptance of a bankruptcy petition (being the time when bankruptcy proceedings are deemed to have commenced) to the bankruptcy declaration of the debtor being made (the “intervening period”), subject to the administrator or the court agreeing otherwise. Accordingly, after the commencement of bankruptcy proceedings in respect of a Mainland Chinese counterparty, a secured party’s right to take possession and hold or dispose of all or any part of the secured assets would be subject to the bankruptcy stay during the intervening period; the secured party may only enforce after it has obtained the prior consent from the administrator of the Mainland Chinese counterparty or the court. The timeline below illustrates the various steps to be taken before a bankruptcy declaration may be made and the potential duration of the intervening period.

1 See here for the previous client bulletins we have published on this topic:
   - A Step Closer to the Recognition of Close-out Netting in China? – Judicial Interpretation of the PRC Enterprise Bankruptcy Law by the Supreme People’s Court (October 2013)
   - Recent Supreme Court Notice – Potential effect on the adoption of Close-out Netting in China (November 2016);
   - China Banking Regulatory Commission’s Reply to Questions on Close-out Netting (August 2017);

2 Promulgated on 16 March 2007 and effective as of 1 October 2007
Technically, the stay during the intervening period equally applies to security over offshore collateral assets taken from a Mainland Chinese company. However, there is also a general market view that, for various practical and jurisdictional reasons, the administrator is unlikely to challenge any enforcement action over offshore collateral assets of the Chinese counterparty. That said, a prudent creditor may wish to obtain consent from the court or the administrator for such enforcement action. To this end, Article 2 of the Bankruptcy Law Interpretation III provides that, during bankruptcy proceedings and with respect to security interests granted by a debtor prior to bankruptcy, the court should uphold the priority of secured creditors in the discharge of the debtor’s debts. There is now therefore a further basis on which an administrator of the debtor or a bankruptcy court can provide consent to a request for enforcement by a secured creditor during the intervening period.

Conclusions

The clarification offered by the SPC in the Bankruptcy Law Interpretation III is helpful to all creditors of Mainland Chinese counterparties. This clarification is particularly timely with more Mainland Chinese counterparties becoming in scope of phase 4 (effective on 1 September 2019) and phase 5 (effective on 1 September 2020) and beyond of global regulatory IM requirements. A foreign counterparty taking offshore collateral from a Mainland Chinese counterparty should have more confidence and comfort in its ability to enforce its security in the event of its Chinese counterparty going bankrupt.

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