Obtain a security interest (guarantee) from a Chinese company

Description

In business world, security is critical. For creditors like traditional banking lenders or industrial companies that are occasionally involved in lending, borrowing or other obligations, a security interest in the form of collateral, guarantee, standby letter of credit is always craved if ever available.

A security interest in this post refers to any collateral-backed mortgage, pledge, lien or personal guarantee, surety etc.

However, there are rules companies shall have to abide by when taking or giving security from or to another party.

1. The Law and Its Meaning

Article 16 of China Company Law provides:

> Where a company invests in other enterprises or provide security for others, such acts shall be so adopted by the resolution of the board of directors, the shareholders' meeting or the shareholders' general meeting according to the articles of association of the company. Where the articles of association of the company impose a limit on the total amount of investment or security or the amount of each individual investment or security, the stipulated limits shall not be exceeded.
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> Where a company provides security to its shareholder or the effective controller of the company, such an act must be adopted by the resolution of the shareholders' meeting or the shareholders' general meeting.
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> The shareholder or the shareholders controlled by the effective controller referred to above shall not participate in the voting of the above matters. Such resolutions must be adopted by more than half of the voting rights represented by the other shareholders present at the meeting.

The Law here basically says that when a Chinese company (including foreign-invested companies in China) provides security to another entity, it should follow the procedures and provisions set out in its articles of association and adopt appropriate resolutions either from board of directors or shareholders meeting.

While this Article 16 represents substantial development on corporate security rules from related provisions in old China Company Law, it has left an enormous confusion in judicial and business practice.

2. Confusion and Questions

The following questions have been often raised in respect of this Article 16 of China Company Law:

(1) what if the security is provided by the company in violation of the articles of association such as there is no resolution or the amount of security is in excess of the amount prescribed in the AOA? Is it still valid?

(2) what if the articles of association fails to stipulate anything related to provision of security by the company? It is very often in China that the AOA is copied based on official template which is very rough and general lacking relevant provisions regarding security/guarantee provision.

(3) will the fact the creditor knows that the the company is offering security for the debtor that is the majority shareholder or effective controller of the company negate the security in the absence of appropriate shareholder resolution?

(4) in all, is the creditor obligated to check up the articles of association of the company that is to provide security to it?

The answers to these questions require correct understanding of the fundamental nature of the articles of association of a company and of the article 16 of China Company Law. Unfortunately people are divided on such issues.

Many hold that China Company Law has made it clear that in order to create a security over a company's assets, the company shall have to arrive at certain resolution in accordance with its AOA. The creditor in whose favor the security is created shall need to look at whether proper resolution is made by the security providing company. In the absence of such resolution, the security is null and void.

Till the publication of a guiding case by China People's Supreme Court in early 2011 did the confusion is partly dispelled. In this guiding case, the China Supreme Court expounded Article 16 of China Company Law as follows:

> In the first place, this Article does not provide that security created in violation of this Article is invalid; secondly, the internal resolution procedures within a company shall not be binding on any third party; thirdly, this Article is not a compulsory/mandatory rule on contract validity; fourthly, it is not conducive to safeguard contract existence and transaction safety to annul a security/guarantee contract based on this Article 16. Further, according to another judicial interpretation on China Contract Law in respect of legal representative of a company acting *ultra vires*, courts should protect the interests of bona fide third party who is not aware of the legal representative of a company signing a security contract in violation of the said company's articles of association. Moreover, in the case of **a limited liability compan**y, the registration and filing of a company's articles of association with local company registry does not itself constitute a constructive notice to third parties. It is not reasonable or doable to require the creditors to examine the articles of association of such limited liability companies or in other words, creditors are not obligated to review such articles of association.

With this clarification by China Supreme Court, much of the confusion seems to disappear. In brief, a court shall not invalidate a security contract concluded by a company on the ground that the creation or provision of the security is in violation of the articles of association of the company unless the security beneficiary is not *bona fide*.

However there are still ambiguities surrounding the issue.

(1) the first one will be the question (3) listed above. In the China Supreme Court judgment quoted above, a *bona fide* third party refers to a creditor who does not know the contents of the articles of association of the guaranteeing company. In this question (3), we are discussing a scenario where the creditor does not know the contents of the AOA but knows that the guaranteeing company is providing security to its majority shareholder or effective controller. Will the security be considered as “void” on the ground that the creditor knows the relationship between the guarantor and the guaranteed and there is no appropriate shareholders resolution?

Again the answers are completely divided. I have seen a few articles written and published in 2013 holding that paragraph 3 of Article 16 is straightforward and crystal clear and no one shall exempt himself from liability because of no knowledge of the law. Creditors that are to take security interests from a company in this case shall be obligated to require a proper shareholder resolution in order to perfect and validate the security interest.

On the other hand, some opinions insist that even in such a scenario, paragraph 3 of Article 16 is still an internal corporate governance rule that shall not and is not intended to affect the validity of the security so provided by the company. In the case of violation of this paragraph 3, no public interests are hurt, so it is not appropriate to annul such security. Shareholders shall have the legal right to seek redress against the corporate officers that violate the rule.

The two schools of opinions sound equally powerful. Parties to such disputes shall need to rely on good lawyers to argue and the result may well rest with what the judge thinks of this matter.

(2) for listed public companies, their articles of association are accessible much more easily, and in this case, should the creditor in whose favor the security or guarantee is provided be presumed to know the contents of the articles of association? Put it another way, is such creditor obligated to check up the articles of association of the security provider that is a listed public company? If yes, there will be no room for a creditor dealing with public companies in security transaction to claim itself to be “bona fide”.

It is even more divided in both theoretical and practice arenas.

In my personal opinion, it will be more unreasonable to require the creditor to ask the company providing security to show or present any resolution upon entering into a security contract. To explicate this viewpoint, it will take a whole new post, and I will leave this for future post.

3. Conclusion

There is no easy conclusion here. Creditors that intend to obtain a security interest from a Chinese company shall firstly distinguish the type of security that is being sought:

(1) a general security provided for a debtor that has no equity relationship;

(2) a special security provided for a debtor that is the majority shareholder or effective controller of the company providing the said security;

(3) a security that is provided by a listed public company

and take different approaches in light of concrete conditions of the security transactions with the help of your lawyer.

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