

The Development of the Financing Leasing System in China

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Abstract

The development of the financing leasing system in China has been relatively slow. This paper primarily introduces the regulations on the financing leasing system by Article 388 of the Chinese Civil Code and related clauses. It addresses the characterization of ownership or security rights, as well as regulations on priority of rights, defective security responsibility, liability for damage to others, maintenance obligations, risk of destruction or loss, public notice, breach remedies, and right enforcement. Furthermore, this paper highlights the differences in regulatory frameworks for movable and immovable property financing leasing in China. Chinese law does not explicitly address issues related to immovable property financing leasing, as it focuses on the functionality of guarantees for movable property and rights due to the clear ownership registration authorities for immovable property, eliminating the issue of "hidden guarantees." Article 65 of the Interpretation of the Civil Code provides comprehensive regulations on the functionalization of financing leasing guarantees.

Keywords: Financing Leasing, Ownership, Security Rights.

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INTRODUCTION

Since its inception in the 1950s, the development of the financing leasing system in China has seen an annual growth rate of 13% worldwide. As a novel financial mechanism, investment method, trade mode, and unique form of credit that combines "financing" and "leasing," financing leasing has evolved into a bridge connecting finance, trade, and industrial production. However, compared to the rapid growth in developed countries, China's financing leasing industry has a noticeably lower market penetration rate. One reason for this lies in the Chinese Civil Code, which classifies financing leasing transactions as a typical financing model distinct from guarantee transactions. However, it characterizes the lessor's ownership as atypical security rights. This characterization affects aspects such as public notice, rights priority, breach remedies, and rights enforcement in financing leasing transactions. Additionally, under the property law section of the Chinese Civil Code, the property rights system starts with ownership and extends to usufructuary rights and security rights, maintaining the traditional

distinction between property rights and non-property rights, absolute property rights, and limited property rights. Security rights are established on the property of the "debtor or a third party," falling under non-property rights. The content of these rights is "priority in satisfaction from the said property," constituting limited property rights. However, in financing leasing transactions, the lessor possesses ownership of the leased property. Although it serves the economic function of guaranteeing the repayment of rental debts, it cannot be integrated into the existing security rights system. Therefore, in China's financing leasing system, lessees do not hold ownership of the leased property during the lease term. Without lessor consent, lessees are prohibited from disposing of the leased property. In cases where lessees fail to pay rent even after notice, lessors can repossess the leased property to terminate the financing leasing contract.

However, the lessor's ownership of the leased property in financing leasing transactions differs significantly from conventional lease transactions, primarily in the following aspects:

Firstly, the lessor in a financing leasing transaction is only obligated to ensure the lessee's possession and use of the leased property (Article 748, paragraph 1 of the Civil Code), without assuming responsibility for defects related to the leased property, liability for harm caused to others, maintenance and upkeep obligations, or the risk of destruction or loss (Articles 747, 749, 750, 751 of the Civil Code). Secondly, after the establishment of a financing leasing transaction, the lessor neither has the right to possess, use, or benefit from the leased property, nor does it have the power to dispose of the leased property (Article 748, paragraph 2 of the Civil Code, Interpretation of Financing Leasing Article 6). The lessor's power of disposal is manifested as the disposition of the rental debt (Interpretation of Financing Leasing Article 4).ⁱ It is also important to note that in Chinese financing leasing contracts, the rental payment is not the consideration for using the leased property. Instead, it is composed of the lessor's cost of purchasing the leased property and a reasonable profit (Article 746 of the Civil Code). Furthermore, upon the termination of a financing leasing contract due to its expiration, the lessor's ownership does not automatically revert. In the case of a buyback arrangement, the ownership of the leased property is typically acquired by the lessee through the payment of a symbolic price (Article 759).ⁱⁱ

Certainly, within the Chinese legal academic community, there is controversy regarding whether Article 388 of the Civil Code transforms the lessor's ownership into security rights in financing leasing transactions, and whether the remedies available to the lessor are those of security rights or ownership. From a literal interpretation, Article 388, paragraph 1, of the Civil Code mentions "guarantee contracts include other contracts with guarantee functions" but does not explicitly state that "financing leasing contracts are guarantee contracts." Although "Explanations on the Draft Civil Code of the People's Republic of China" mention financing leasing, it merely expresses "clarification of the guarantee function of non-typical guarantee contracts like financing leasing" without explicitly stating that "financing leasing contracts are guarantee contracts." From a systemic interpretation, Article 388 is located within the "Property Rights Section" rather than the "Contract Section." Ideally, it should address property rights issues, but the contradiction arises as it deals with matters falling under "guarantee contracts." According to scholars involved in drafting the Civil Code, the motivation behind drafting Article 388 was to improve the business environment and eliminate hidden guarantees.ⁱⁱⁱ However, characterizing financing leasing contracts as guarantee contracts cannot directly achieve this goal. Contracts can only serve as a basis for resolving the rights and obligations of the parties involved but cannot address the issue of rights publicity. To eliminate hidden guarantees and improve the business environment, it is necessary to implement property rights registration and publicity.

In reality, Article 388 of the Civil Code expands the scope of guarantee contracts to include financing leasing contracts and, by specifying the unified registration of movable property and rights guarantees, it ensures the registration and publicity of the leased property in financing leasing transactions. This truly achieves the registration and publicity of the lessor's rights, avoids "hidden guarantees," and improves the business environment. In the case of movable property financing leasing, conflicts of rights are quite common, such as when lessees transfer, pledge, mortgage, invest, or dispose of the leased property in other ways. This significantly increases the risk associated with financing leasing transactions. With clear and predictable priority rules, parties can assess transaction risks in advance and determine the corresponding transaction prices. Articles 414 and 415 of the Chinese Civil Code establish the general rule of "first to register, first in priority" when it comes to competing security rights. Article 414, paragraph 2, states: "For other registrable security rights, the order of repayment shall be governed by the provisions of the preceding paragraph." It can be observed that although the lessor's ownership serves a security function and has been granted registration capability, it does not necessarily fall under the specific definition of "security rights" as provided in Article 414, paragraph 1.^{iv} However, according to the provisions of Article 388, paragraph 1, which define security rights to include both typical security rights (mortgages, pledges, and liens) and non-typical security rights (such as lessor's ownership in financing leasing transactions or seller's ownership in ownership retention transactions), it is appropriate to interpret the term "security rights" in Article 414, paragraph 2, as expansively including registrable rights with security functions.^v

This interpretation allows for a broader application of the registration and priority rules, helping parties in financing leasing transactions better assess risks and establish transaction prices in a more predictable manner. In the context of real estate financing leasing, such as for properties like houses and land use rights, the ownership of the leased property is registered with a statutory registration authority, and the nature of the registration is ownership (e.g., ownership of a house). It cannot be interpreted as "security rights." In reality, neither the Chinese "Explanations on the Draft Civil Code" nor statements from scholars involved in legislation mention issues related to real estate financing leasing. They focus on functional security legislation in the context of movable property and rights because real estate financing leasing has a clear system of ownership registration, eliminating the issue of "hidden guarantees." As a result, whether real estate financing leasing falls under the definition of a "guarantee contract" as stated in Article 388, and whether the ownership registration can be interpreted as "security rights," remains unclear. The reason for this ambiguity might be that real estate financing leasing does not occupy the mainstream in the practice of financing

leasing transactions in China. This underscores the importance of considering the specific legal context and practices in each jurisdiction when interpreting and applying legal provisions, especially in areas where there may be ambiguity or limited precedent.

Finally, Article 65 of the Interpretation of the Civil Code on guarantees provides comprehensive regulations for the functionalization of financing leasing guarantees. Its first and second paragraphs correspond to the requests for the payment of all remaining rent and the termination of the contract and the retrieval of leased property in Article 752 of the Civil Code. The first paragraph not only explicitly supports the litigation request for the payment of all rent but also further stipulates that it is possible to simultaneously assert "the payment of the price obtained from the auction or sale of the leased property," and it can follow the procedural rules for the realization of security rights under the Civil Procedure Law to pay the rent from the proceeds. This has a significant impact on the lessor's remedies in that they can request the payment of all rent and prioritize the payment from the proceeds of the leased property. Economically, the lessor can simultaneously assert both the debt and the property right. While the debt claimed is the entire rent, what is being asserted is a security right,

which results in (priority) payment in terms of value, rather than ownership.^{vi}

The exercise of the security right aims to clear the debt. At this point, the price of the leased property must be used for the purpose of clearing and deducting the rent debt. In summary, while the United Nations Legislative Guide on Secured Transactions recommends a functional approach to secured transactions legislation in different countries, it acknowledges that there are both "uniform" and "non-uniform" paths available, considering the differences in legal traditions among nations.^{vii} China has adopted a functional formalism approach, recognizing financing leasing contracts as a distinct and typical transaction type separate from chattel mortgage contracts. This recognition is achieved through Article 388, which includes financing leasing transactions under the security rights system as "other contracts with guarantee functions." Within the existing framework of absolute ownership and property debt division, this approach incorporates functional elements, balancing a series of policy choices that affect the interests of lessors, lessees, and third parties. However, its effectiveness and coherence will still need to be tested and refined through judicial practice.

ⁱCheng Weidong, "On the Ownership of International Financing Leased Assets," in "Annual Review of Chinese International Private Law and Comparative Law" (Volume 3), Law Press, 2000, pp. 362-363.

ⁱⁱGao Shengping, "The Guarantee Function of Financing Lease Transactions in the Civil Code," in "Political and Legal Forum," Issue 41, 2023, page 89.

ⁱⁱⁱLong Jun, "The System of Chattel and Rights Security in the Civil Code," in "Legal Studies," Issue 6, 2020, pages 23-27.

^{iv}Wang Chen, "Explanations on the Draft Civil Code of the People's Republic of China - Delivered on May 22, 2020, at the Third Session of the Thirteenth National People's Congress," in "Bulletin of the Standing Committee of the National People's Congress of the

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^vLiu Guixiang, "Several Major Issues Concerning Guarantees in the Civil Code," in "Application of Law," Issue 1, 2021.

^{vi}Li Zhigang, "The Nature of the Property Rights and Remedies of Financing Lease Lessor in the Context of Functional Security Legislation - A Transformation or Expansion?" in "Review of Economic and Trade Law" (Final Typeset), Page 9.

^{vii}Gao Shengping, "Functionalism and Formalism in Chattel Secured Transactions - The Treatment Mode and Its Impact in China's Civil Code," in "Foreign Social Sciences," Issue 4, 2020, Page 8.