

PRC Supreme Court's Latest Provisions on the Trial of Private Lending Cases

In August 2015, the Supreme People's Court ("Supreme Court") of the People's Republic of China ("PRC") issued the Provisions of *the Supreme Court on Several Issues concerning the Application of Law in the Trial of Private Lending Cases* ("Provision 18"), which has become effective on September 1, 2015. Among various breakthroughs the Provision 18 has made, we would like to draw your attention to the following ones.

1. Legalization of Loan between Legal Entities

Before issuance of the *Provision 18*, validity of private lending contracts signed between legal entities has always been questionable. Due to the restriction of relevant financial administrative regulations, the PRC courts held such contracts invalid for a long time. Although such strict interpretation was loosened in recent years, practices by PRC courts in different areas of China have not been unified.

Notwithstanding the above, *Provision 18* stipulates that a private lending contract entered between legal entities for the purposes of production and business operation would be regarded as valid, provided it does not have the circumstances under Article 52 of the *PRC Contract Law* and Article 14 of *Provision 18*, which are:

- Article 14 of *Provision 18*

The People's Court shall hold a private lending contract invalid,

- when the credit loan is fraudulently taken from financial institutions, and usurious relending is made to the borrower (the borrower knows it or should have known it in advance);
- when the loan is obtained from other companies or by fund-raising from the employees, and then relent to the borrower for profit purposes (the borrower knows it or should have known it in advance);
- when the lender knows or should have known in advance that the borrower takes the loan for criminal activities but has still provided the loan;
- when public order or public morals are violated; or
- when laws, administrative regulations and other mandatory provisions are otherwise violated.

- Article 52 of the *PRC Contract Law*

In any one of the following situations, a contract shall be invalid:

- One party concludes the contract through the use of fraudulent or coercive means, causing detriment to the interests of the State;
- The contract involves a malicious conspiracy which is detrimental to the interests of the State, a collective or a third party;
- Illegal intentions are concealed beneath an appearance of legality;
- There is detriment to social and public interests; or
- The mandatory provisions of laws and administrative regulations are violated.

Meanwhile, please note that *Provision 18* mentions that private lending contracts between legal entities shall be entered for the purpose of production and business operation, but does not provide a clear concept of “for the purpose of production and business operation”. We understand that private lending shall not be the main business of said legal entities. Otherwise, it would be regarded as operation beyond the registered business scope and said legal entities may face administrative penalties, since carrying out loan business is regarded as business activities of financial institutions, which shall be approved by the China Banking Regulatory Commission. For your information, illegal engagement in the business activities of financial institutions may face following penalties:

- Confiscate the illegal income;
- If the illegal income is more than 500,000 yuan, a fine of not less than one time and not more than five times the illegal income shall be imposed. If there is no illegal income or the illegal income is less than 500,000 yuan, a fine of not less than 500,000 yuan and not more than 2 million yuan shall be imposed;
- The business license shall be revoked; and
- Where a criminal offence is constituted, criminal liability shall be pursued in accordance with the law.

2. Regulatory Change regarding the Interest Rate of Private Lending

In the past, interest rate of private lending was regulated to be not exceeding four times of the bank interest rate of loan of the same kind. However, *Provision 18* regulates the same by setting fixed ranges for the interest rate as follows:

- If the annual interest rate does not exceed 24%, the PRC courts will support the lender’s request for the borrower to pay such interest;
- If the annual interest rate exceeds 24% but is no more than 36%, the loan will be treated as *naturalis obligatio*. Once paid accordingly without damaging the interests of the state, the collective or the third party, the borrower could not claim the lender to return the part of interest paid exceeding 24% as the annual interest rate. However, the PRC courts will not support the lender’s request for the borrower to pay the part of interest exceeding 24% as the annual interest rate; and

- If the annual interest rate exceeds 36%, the agreement on the exceeding part of the interest shall be invalid. The PRC courts will support the borrower's request for the lender to return the part of interest paid exceeding 36% as the annual interest rate.
- Please note that the above ranges are also applicable to overdue interest rate agreed in private lending contracts. And if the overdue interest and liquidated damages or other expenses are both agreed in the private lending contracts, the sum of these payments will be regulated according to the above ranges.

3. Limited Recognition on Purchase Agreements as the Guarantee for Private Lending Contracts

In practice, the lender and the borrower will sometimes sign a purchase agreement as the guarantee for a private lending contract. If the borrower fails to pay off the loan when the loan is due, the lender will request the borrower to perform the purchase agreement (*lex comisorio*).

According to *Provision 18*, if the lender makes the above request before the court, the court shall hear the case based on the legal relation of private lending, explain to the party concerned to change his/her claims. Where the party concerned refuses to make the change, the court shall reject the lawsuit.

Where the judgment made based on legal relation of private lending is effective, and the borrower refuses to perform the monetary obligation determined by the effective judgment, the lender may apply for auction of the subject matter of the purchase agreement to pay off the debt. The borrower or lender has the right to claim back or compensation in connection with the balance between the money obtained from the auction and, the principal and interest of the loan payable.

Regarding the applicability of the *Provision 18*, please note that, according to the *Notice on Studying and Implementing the Provision 18* issued by the Supreme Court on August 28, 2015, if a private lending contract is regarded invalid according to the judicial interpretations applicable when said contract was established, but is regarded valid according to *Provision 18*, *Provision 18* shall be applied. However, for cases still under trial of first, second instance or retrial upon the coming-into-force of *Provision 18*, judicial interpretations issued before the *Provision 18* shall be applied.

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