

THE
TRANSPORT
FINANCE LAW
REVIEW

FOURTH EDITION

Editor
Harry Theochari

THE LAWREVIEWS

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PREFACE

The Transport Finance Law Review is intended to provide the industry with a guide to transport finance today, in each of the key jurisdictions globally in which aircraft, rolling stock and ships are financed.

Traditional asset finance, in the form of bank debt, has long been the mainstay of the transport sector. It is apparent, however, that debt finance alone is no longer sufficient to meet the needs of the global aviation, rail and shipping sectors. As a result, the transport finance sector is undergoing a revolution, requiring its legal advisers to respond by providing clients with a far broader set of legal skills and market knowledge than was previously required.

Ten years on, the impact of the global financial crisis on the transport sector continues to be felt. Following the crisis, new regulation intended to prevent future crises has been introduced, notably Basel III and Basel IV, which are designed to strengthen banks' balance sheets by requiring them to hold additional capital against their loan books. The impact on an industry as capital-intensive as the transport sector is that long-term lending is now less attractive. This has led certain banks to exit the asset finance market altogether, with a number of banks taking the decision to sell all or part of their loan books to help them meet the new capital requirements.

However, it must be said that there is a marked difference in the attitude of banks and financial institutions when considering loans to the aviation and rail sectors and the shipping sector. At the time of writing, capital is readily available to much of the aviation industry, and there is competition between banks for what are considered to be the best customers. The capital markets are also open for business for the aviation sector, and there is a flow of equity investments from both hedge funds and private equity as well as large-scale investments from Asia (and China, in particular). In the rail market, where significant investment is being made globally, participants are increasingly looking outside their traditional markets in search of new opportunities. So far as the shipping industry is concerned, the amount of debt finance available to it has fallen dramatically, and alternative sources of finance, such as private equity, hedge funds, bond markets and capital markets, have also reduced greatly. This is not surprising to many as shipping gradually emerges from possibly the worst recession it has ever experienced in modern times, impacting across the entire spectrum of the industry, from dry bulk to tankers and from container ships to offshore vessels.

Asset finance in its traditional form is now available from relatively few banks, who in turn are prepared to lend to relatively few names, which are usually leaders in their relevant sectors. Despite this, the majority of capital available to the transport sector continues to take the form of bank debt. Tenors are shorter, however, and borrowing is more expensive. For a sector that requires billions of dollars to fund itself annually, a shortfall in funding is inevitable.

In response to the financial crisis, many companies operating in the transport sector reduced their debt, in preparation for more difficult trading conditions. Now, however, aviation and rail in particular face an upsurge in demand as passenger numbers rise, particularly in developing economies, and while industrial shipping remains bruised by overcapacity and lower freight volumes, demand in certain subsectors is growing, notably in the cruise sector and particularly in new markets.

This, coupled with the introduction of increasingly sophisticated and more costly technology, including fuel-efficient jets, high-speed rail and high-specification cruise vessels, is leading to increased funding requirements in many areas of the transport sector.

New participants see significant opportunities in transport and are entering the market using innovative new structures.

Capital markets and private equity structures now account for a substantial proportion of the transport finance market. In the shipping industry, well-known private equity players invested their own cash and continue to support the businesses into which they have invested rather than writing off these amounts, in the belief that the cyclical nature of shipping will result in some returns in the medium to long term. Other private equity investors consider that we have reached the bottom of the shipping cycle and that investments made now may yield attractive returns in the short term, while some funds are buying loans from traditional banks at a large discount in order to see immediate returns. In the aviation industry, leasing firms, who are frequently supported by private equity players, now account for around 40 per cent of the major aircraft manufacturers' sales. In the case of rail, privatisations are being considered in some jurisdictions and new investors are being attracted to the industry by the commitments made by governments worldwide to improve existing infrastructure and invest in new, sophisticated rail links. China's Belt and Road initiative is an example of a government-led programme that is likely to have a far-reaching impact on rail activity and indeed, on all transport and infrastructure assets.

The aviation, rail and shipping industries each have their own unique characteristics and need lawyers with a deep understanding of how each of these complex industries operates. A detailed knowledge of the principles of asset finance is now also required, combined with the ability to advise on new capital markets and corporate structures. In addition, while the majority of asset financings in the transport sector tend to be governed by New York or English law, an understanding of the principles of local law in the key jurisdictions in which transport assets are registered is also of great importance.

We have sought contributions from jurisdictions that play a leading role in the financing of transport assets. Each chapter provides an overview of the transport finance industry in these jurisdictions, with an analysis of how key lenders have changed over the past five years and how the financing of assets has developed as a result. Contributors have provided an overview of the legislative framework for transport finance and financial regulation affecting lenders to the transport sector. Authors have also been asked to review any significant innovations and notable recent and pending financings and cases, and to provide assessments of how the transport sector is likely to continue to develop in their markets.

I would like to thank the contributors to this volume. Their efforts are deeply appreciated and represent a substantial contribution to the transport law library during a period of transformation for the sector.

Each contribution reflects the significance of the transport sector today, and the need for readily available funding for industries that underpin the global economy by transporting people and commodities around the world every day.

While we are now beginning to see new banks entering the asset finance market, traditional asset finance is likely to remain in short supply in the coming years, and innovation will remain at the centre of our industry. The days of one asset financed by one bank have passed and, in response, lawyers have had to become increasingly nimble as clients require advice on developing intricate joint-venture agreements and complex capital market products. It is an incredibly exciting time to be a lawyer in this field, as our contributors demonstrate in the following chapters.

Harry Theochari

Norton Rose Fulbright

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CHINA

*Wang Shu, Zhu Jun, Zhang Ling and Ren Jiyu*¹

I INTRODUCTION

i The transport finance industry

The transport finance industry is a fast-growing business in China mainly because the transportation industry in China experienced rapid growth and expansion in recent years during the urbanisation of the country and the modernisation of China's transport infrastructure.

Aviation

China's civil aviation market is one of the most important and rapidly growing aviation markets in the world. According to the data published by Civil Aviation Administration of China (CAAC) and China Aviation Daily, during the period from January to November of 2017, the profits of China's civil aviation industry is 69.28 billion yuan, increased by 16.4 per cent from the same period of the last year. China's airlines have imported more than 400 commercial aircraft in 2017, and the entire PRC commercial aircraft fleet has reached to 3,300 aircraft. The number of international routes operated by Chinese airlines increased from 427 in 2013 to 778 in 2017.

The civil aviation finance industry in China is also growing rapidly in line with the expansion of the Chinese commercial aircraft fleet. While the industry used to be dominated by foreign lessors and commercial banks, more and more PRC domestic lessors and investors have started their aircraft finance business and are expanding their business quickly, mostly by using PRC tax-bonded area leasing and financing structures. Due to the fluctuation in the exchange rate of yuan since 2015, some PRC airlines started to seek yuan financing instead of US-dollar financing for their acquisition of aircraft. Some large PRC lessors have built up their offshore aircraft fleet as well and have extended their business to the Middle East, South Asia, South America and Europe. A large amount of Chinese funds flowed into the overseas aviation market.

Shipping

China plays an important role in the world's shipping industry in terms of its ship-building and water transportation capacities. According to data published by the China Association of the National Shipbuilding Industry, during the period from January to November of 2017, there were 1,407 national shipbuilding enterprises with prime operating revenue of

¹ Wang Shu and Zhu Jun are partners, and Zhang Ling and Ren Jiyu are associates at Han Kun Law Offices.

590.04 billion yuan, a decrease of 8 per cent from the same period last year. In 2017, China's completed tonnage is 38.04 million and the new order tonnage is 32.23 million, representing 39.1 per cent and 44.4 per cent of the global market share, ranking first in the whole world.

Despite the downturn of the shipping market after the financial crisis in 2008, certain Chinese lenders have continued to be active in ship financing. The leading banks that provide shipping finance include the Bank of China, the Export-Import Bank of China and the China Development Bank. More and more financial leasing companies also participated in the shipping finance industry through financial leases and bareboat charters.

Rail

Due to its importance in China's economy, China's rail industry is highly controlled and influenced by the state. Before 2013, most of China's rail assets were directly owned and operated by the Ministry of Railways and its local bureaus. After 2013, China established the China Railway Corporation (CRC), which is one of the largest state-owned companies in China, to own and operate China's rail assets. After the establishment of the CRC, the Ministry of Railways was dissolved and incorporated into the Ministry of Transportation.

Due to the CRC's dominant position in the industry, the finance of rail equipment is mainly through the CRC's bank lending, bond issuance and financial leases. The state also encourages private capital to invest in the railway sector, especially for the construction and operation of intercity railways, urban (suburban) railways, railways designed for resource development and branch railways.² The public-private-partnership (PPP) model, which is very popular in China to attract private capital in infrastructure industry, has also been adopted in the rail industry. In 2017, the total investment in fixed assets of the railway in China exceeded 801 billion yuan.

ii Recent changes

China has boosted bank credits, cut taxes and embarked on a massive infrastructure spending programme in an effort to mitigate the adverse effects of the financial crisis in 2008 and the slowdown of the world economy. These stimuli extend to the transport industry as well, and it is expected that during the period from 2016 to 2020, China will invest 15 trillion yuan in the transport sector (which includes 3.5 trillion yuan in rail transportation, 7.8 trillion yuan in road transportation, 65 billion yuan in civil aviation and 5 billion in water transportation).

The main transport financiers in China market include (1) the four big state-owned commercial banks, which are the Bank of China, the China Construction Bank, the Industrial and Commercial Bank of China, and the Agricultural Bank of China, (2) the policy banks, which include the China Development Bank, and the Export-Import Bank of China, (3) certain large commercial banks focusing on the transport section, such as the Bank of Communications, (4) the financial leasing companies and the domestic and foreign-invested leasing companies, and (5) the foreign banks that specialise in the transport finance sector.

The noteworthy changes in China's transport finance sector in the past five years include: (1) the fast growth of China's leasing industry and the rise of Chinese leasing companies acting as lessors; and (2) the reform of China's value-added tax system and after

2 The NDRC, the Ministry of Treasury, the CBRC and other authorities, Fa Gai Ji Chu [2015] No. 1610, the Implementing Opinions on Encouraging and Expanding the Investment of Private Capital in the Construction of Railways.

the reform, China lessees are permitted to deduct their value-added taxes paid for capital expenditures, and (3) the establishment of a number of tax-bonded areas and free trade zones and these areas and zones help to create Chinese tax-bonded leases structures for aircraft and ship finance.

On 3 February 2017, the State Council published the 13th Five-Year Plan for Modern Integrated Transportation System Development (the Plan), according to which, the PPP model will be promoted in the transportation area, more credit funds will be provided by policy financial institutions and development financial institutions, and insurance funds will be encouraged to invest in transport infrastructure through credit, equity and other means. At the same time, international cooperation in overseas transportation through investment, leasing, technical cooperation and other means is also highly valued and promoted by the government.

II LEGISLATIVE FRAMEWORK

In China, the sources of laws that may affect the transport finance include:

- a* the laws made by the National People's Congress (NPC) and its Standing Committee;
- b* the administrative regulations made by the State Council;
- c* the administrative rules made by the ministries, commissions and departments of the State Council;
- d* the local regulations and autonomous regulations made by the local people's congresses and their respective standing committees;
- e* the local administrative rules made by the local governments;
- f* the judicial interpretations to the relevant laws made by the Supreme People's Court of China; and
- g* the international treaties and conventions approved by the NPC and its Standing Committee.

For transport finance transactions that do not involve foreign parties, the legal documentation has to be governed by Chinese law. For the cross-border transport finance transaction, the parties are allowed to select the governing law of the documentation they prefer, and the laws of England and New York are usually preferred by the financiers.

On 28 October 2008, China ratified the Cape Town Convention on International Interests in Mobile Equipment and the Aircraft Protocol. According to China's declarations, the Cape Town Convention do not apply to Hong Kong SAR and Macao SAR. To implement the Cape Town Convention, in 2009, CAAC issued the Measures on Regulation of Applications for Authorisation Codes for Registrations with the International Registry and the Administrative Procedures for the De-registration of Nationality of Civil Aircraft according to an IDERA.

i Domestic and international law and regulation

China's transport industry is regulated by different regulatory agencies, which include:

- a* the CAAC for civil aviation;
- b* the National Railway Administration of China for railway transportation;
- c* the Water Transportation Agency under the Ministry of Transportation for domestic water transportation; and
- d* the Maritime Safety Administration (MSA) of China for maritime transportation.

Aviation

In China, the nationality, ownership, mortgage rights, priority rights and leasehold interest and airworthiness management in respect of China-registered civil aircraft and the Chinese civil aviation industry are governed by the Civil Aviation Law of China (the Civil Aviation Law) and the administrative rules and orders issued by the State Council and the CAAC.

The CAAC maintains a civil aircraft nationality register (CAAC Nationality Register) and a civil aircraft rights register (CAAC Rights Register). The CAAC Nationality Register is an operator-based register and is now operated by the Airworthiness Department of CAAC. The CAAC Rights Register is now operated by the Legal Department of CAAC and can register the relevant party's rights to civil aircraft. To date, there is no separate rights register for aircraft engines.

The CAAC also published a rule on 16 May 2017 that requires the owner of an unmanned aircraft system (UAS), sometimes called a drone, to register drones of a take-off weight of 250 grams or over with the CAAC's UAS registration system.

China has designated the CAAC as an authorising entry point for registration on the International Registry. According to the CAAC's regulations, the parties have to obtain AEP codes from the CAAC to perform registrations on the International Registry against aircraft with Chinese nationality. The Legal Department of the CAAC is now responsible for granting the AEP codes.

Shipping

The branch offices of the MSA are the authorities that administer the nationality and rights registrations of vessels that fly the Chinese flag according to the Maritime Law of China, the Regulations on Vessel Registration of China and the administrative rules issued by the MSA. The vessels that can fly the Chinese flag include (1) vessels that are owned by Chinese citizen who has domicile or main place of business in China, (2) vessels that are owned by an enterprise legal person established according to the laws of China and having its principal place of business in China (if such legal person is a foreign-invested company, the equity owned by the Chinese investor is no less than 50 per cent unless otherwise permitted by the MSA); (3) the public vessels of the Chinese government or the vessels owned by Chinese institutional legal persons; and (4) the vessels on bareboat charter to PRC entities.

iii Specific practices

Compliance with China's foreign exchange regulations is essential for foreign financiers' financing to a Chinese debtor in transport finance, particularly in respect of the rules on foreign debt control and provision of cross-border security for the financing. The State Administration of Foreign Exchange (SAFE) is the authority responsible for enforcement of China's foreign exchange regulations. The completion of the applicable foreign debt and cross-border security approval, filing and registrations requirements are normally conditions precedent for the disbursement of the financing.

Foreign debt regulation

For regulation purpose, the foreign debt refers to the financial indebtedness (which may be in the form such as a loan, a cross-border financial lease or an issuance of bonds) owed by a Chinese debtor to a foreign creditor. To borrow a foreign debt, the Chinese debtor needs to ensure that it has a sufficient foreign debt quota (such quota is determined according

to a formula by reference to the Chinese debtor's net assets, the applicable cross-border finance leverage ratio and China's macro-economy adjustment factor), and complete the filing with the National Development and Reform Commission (NDRC) or its authorised local counterpart (since 14 September 2015, the financial indebtedness of the offshore entity controlled by a Chinese enterprise is also required to be filed with the NDRC). In addition, after the execution of the relevant foreign debt agreement, the Chinese debtor needs to register such agreement with the SAFE and such registration is a pre-condition of the Chinese debtor to open a bank account to receive the funds of the foreign debt and to remit funds out of China to repay the foreign debt.

Cross-border security regulation

According to the regulations of the SAFE, a security arrangement may constitute a cross-border security if:

- a* the provider of the security makes a legally binding undertaking to the creditor that it will perform the relevant payment obligation according to the security agreement; and
- b* such arrangement may cause cross-border payment and receipt of funds or cross-border transfer of asset ownership.

The security arrangement may take the form of a guarantee, pledge, mortgage and other forms of security that are permitted by applicable law.

For a cross-border security arrangement, if the provider of the security is established and registered in China, and the debtor and the creditor are established and registered in offshore jurisdictions,³ the provider of the security is required to register such cross-border security with the SAFE. There are also certain conditions for using such cross-border security structure in certain particular types of finance, including (1) if the secured debt is the issued bonds, the Chinese security provider shall have, directly or indirectly, equity interest in the debtor; (2) if the funds of the secured debt are used to acquire equity interest in or to be borrowed to an offshore entity, the acquisition of such equity interest and the lending shall comply with the outbound investment regulations of the Chinese authorities; (3) if the secured debt is the payment obligation under a derivative transactions of the debtor, the purpose of such derivative transaction shall be for hedging only, and such transaction shall be within the debtor's business scope and duly authorised by its shareholders, (4) the funds of the secured debt shall only be used for relevant expenses within the normal business scope of the debtor concerned, and cannot be used to support the debtor in engaging in transactions beyond the normal scope of its business, for arbitrage under fabricated trade background or for other forms of speculative transactions, (5) the funds of the secured debt shall not directly or indirectly be repatriated by way of making securities investment but can be directly or indirectly transferred for domestic use by domestic lending, equity investment or otherwise. The eligibility of the debtor, the use of funds of secured debt, the relevant transaction background, the expected source of funds for repayment and the possibility of the performance of the security are examined by the SAFE or a bank.

If the provider of the cross-border security is established and registered in an offshore jurisdiction, and the debtor and creditor are established and registered in China,⁴ the following conditions need to be satisfied: (1) the Chinese debtor has to be a non-financial

3 Such cross-border security structure is called 'Neibaowaidai' in Chinese.

4 Such cross-border security structure is called 'Waibaoneidai' in Chinese.

institution registered in China; (2) the Chinese creditor has to be a financial institution registered in China; (3) the secured debt has to be a yuan commitment or foreign exchange lending (other than entrusted loans) or legally binding lending commitment; and (4) the form of the security must comply with Chinese law and the applicable foreign law. According to the rules of the SAFE, the Chinese creditor needs to report the relevant data of its finance secured by such security structure to the SAFE, and after enforcement of the security, the Chinese debtor needs to register its obligation to indemnify the offshore security provider as a foreign debt.

In respect of the rental payments, even though in general, no foreign currency shall be circulated within the territory of China and no foreign currency shall be used for pricing or settlement purposes, according to the Notice of Foreign Exchange Administrative on Finance Leasing promulgated by the SAFE on 13 October 2017, the financial leasing companies regulated by the CBRC, foreign-invested financial leasing companies and domestic financial leasing companies regulated by Ministry of Commerce of China (MOFCOM) are capable of receiving foreign currency rental payments if more than 50 per cent of the funds used to purchase the leased asset are from a domestic foreign currency facility or foreign currency foreign debt.

As for the operating lease, there are no national policies with respect to receiving foreign currency rental payments, the lease companies conducting operating lease business in Tianjin Dongjiang Free Trade Port Zone were permitted to receive the foreign currency rental payments in the case of operating leases with Chinese domestic lessees if more than 50 per cent of the funds used to purchase the leased asset are from a domestic foreign currency facility or foreign currency foreign debt, or the leased asset is leased from an offshore lessor and the rental payments need to be paid in foreign currency. Such policy was subject to a two-year trial period and ended at the end of 2017. It has not been determined what regulations will apply to lease companies conducting operating leases in other bonded areas in China and whether such policy will be further amended after the conclusion of the trial period.

III FINANCIAL REGULATION

China's financial industries are highly regulated.

The People's Bank of China (PBOC) is the central bank of China, which formulates and implements China's monetary policies. The PBOC is also responsible for maintaining and supervising China's payment, clearing and settlement systems, regulating China's interbank markets and manages China's foreign exchange and gold reserves. The PBOC oversees SAFE which is the regulator of China's foreign exchange and normally, the head of SAFE is also a vice president of the PBOC.

The China Banking Regulatory Commission (CBRC) is the regulator of China's banking industry and it supervises banks, financial leasing companies, asset management companies, trust and investment companies as well as other deposit-taking financial institutions. Certain foreign-invested leasing companies and domestic leasing companies are regulated and supervised by the MOFCOM.

The China Securities Regulatory Commission (CSRC) is the regulator of the securities, capital and futures industries of China, and the China Insurance Regulatory Commission (CIRC) has the power to regulate and supervise China's insurance market.

i Regulatory capital and liquidity

China never implemented Basel I and moved directly onto Basel II and Basel III. Since 2012, China has issued a number of regulatory guidelines and rules to set forth the roadmap and details to implement Basel III in China, including:

- a* the core elements of Basel III standard in the Regulations on Management of Commercial Bank's Capital promulgated in June 2012 (the Capital Regulations);
- b* the supplementary documents for implementation of the Capital Regulations promulgated in October and November 2012;⁵ and
- c* the implementation policies and documents as to regulation of commercial banks' capital promulgated on 19 July 2013.⁶

The Capital Regulations and their supplementary documents and implementation policies and documents comply with the implementation schedule set forth by the Basel Committee on Banking Supervision for Basel III, and apply to all commercial banks incorporated in China, and certain non-bank financial institutions (including group financial companies, consumer finance companies, financial leasing companies, automobile finance companies, lending companies, and rural credit cooperatives). The Capital Regulations do not apply to policy banks that do not accept deposits from the public.

In a few areas, China has adopted a stricter approach than the minimum standards prescribed by Basel, including:⁷

The Capital Regulations not only apply to China's international banks, but also apply to all other commercial banks, including those small banks and local banks.

There is no phase-in arrangement for the minimum capital ratio. Commercial banks should meet a minimum ratio of 5 per cent CET1, 6 per cent Tier 1 and 8 per cent total capital as of 1 January 2013. The minimum requirement for CET1 is 5 per cent rather than 4.5 per cent as required by Basel. The requirement for CET1 including the capital conservation buffer is 7.5 per cent instead of 7 per cent as required by Basel.

The Capital Regulations generally apply a risk weight of 1,250 per cent to commercial banks' equity investments in commercial entities, with the only exception of a 400 per cent risk weight applied to 'equity investments in commercial entities passively held by the bank within the legally prescribed disposal period' and 'equity investments in commercial entities made by the bank due to policy reasons and with the special approval of the State Council'.

Under the Standardised Approach for credit risk, claims secured by residential property are risk weighted at 50 per cent rather than 35 per cent, the minimum required by Basel.

5 The full names of these documents are the Supervisory Guidance on Capital Instruments Innovation for Commercial Banks and the Notice of the CBRC on Transition Arrangements for the Implementation of the Capital Rules for Commercial Banks.

6 These policies and documents include the Notice on Measurement Rules of Capital Requirements for Bank Exposures to Central Counterparties (CCPs); the Notice on Enhancing Disclosure Requirements for Composition of Capital; the Notice on Regulatory Policies for Implementing IRB of Commercial Banks; and the Notice on Policy Clarification of Capital Rules. These policies and documents provide for further clarifications and rules on exposures to central counterparties (CCPs), disclosure requirements for capital instruments, requirements for internal ratings based approach (IRB) implementation and certain technical clarifications.

7 The Assessment of Basel III regulations-China published by Basel Committee on Banking Supervision on 27 September 2013. The full report is available at <http://www.bis.org/press/p130927.htm>.

ii Supervisory regime

Lending is a regulated business in China and Chinese law generally prohibits an unlicensed PRC company from lending money to another PRC company (the cross-border loans are not subject to such prohibition). Therefore, the lendings between PRC companies are usually done through a licensed PRC bank through an 'entrusted loan'. Under an entrusted loan, the lender, the borrower and the entrusted PRC bank will enter into an entrusted loan agreement and the lender will disburse the loan to the borrower through the entrusted bank. The lender, not the entrusted bank, shall bear all borrower's credit risks by itself. After the promulgation of the 'Administrative Measures for Entrusted Loans of Commercial Banks' on 5 January 2018, the lender could basically only use its own proprietary funds to disburse 'entrusted loan', and the use of the 'entrusted loan' is also strictly constrained.

China also has mandatory requirements on the portion of the loan provided by a PRC bank in the whole investment amount of the financed project (the maximum lending ratio). Such maximum lending ratios vary according to the industry of the financed project. As to transport related industries, the maximum lending ratios are 20 per cent for railway, road and urban railway transport project, and 25 per cent for airport, harbour and coastal and inland waterway projects. The State Council is empowered to change such ratios from time to time according to the circumstances of China's economy.

The Chinese financial institution's ability to provide finance to a debtor may also be limited by the applicable regulatory requirements. For example, for a financial leasing company regulated by the CBRC, its ability to provide financial leasing finance to a lessee may be limited by:

- a* the single customer finance concentration ratio: i.e., the unpaid balance of all financial leases to a single company may not exceed 30 per cent of its net capital;
- b* the single group customer finance concentration ratio: i.e., the unpaid balance of all financial leases to all companies within the same group may not exceed 50 per cent of its net capital;
- c* the single related-party finance ratio: i.e., the unpaid balance of all financial leases to a single related party of the financial leasing company may not exceed 30 per cent of its net capital;
- d* the all related-party finance ratio: i.e., the unpaid balance of all financial leases to all related parties of the financial leasing company may not exceed 50 per cent of its net capital; and
- e* the single shareholder finance ratio: i.e., the unpaid balance of all financial leases to a single shareholder of the financial leasing and all related parties of such shareholder may not exceed all capital contributed by such shareholder.

The lendings and financial leases from offshore companies to Chinese debtors are subject to the foreign debt regulations discussed above, and the relevant Chinese debtor shall have sufficient foreign debt quota and complete the relevant foreign debt filing and registration procedures.

IV SECURITY AND ENFORCEMENT

The lenders usually take a mortgage⁸ over the financed aircraft, vessel and rolling stock as security of the finance. Pledge over financed aircraft, vessels and rolling stock is rare as for perfection of pledge interest, the pledged asset need to be possessed by the pledgee or a person on behalf of the pledgee. According to the Civil Aviation Law and the Maritime Law of China, the mortgage over a civil aircraft shall be governed by the laws of the state where the aircraft is registered and the mortgage over a ship shall be governed by the law of the flag state of the ship. In practice, as to the finance of aircraft registered in China but owned by offshore entity, it is not unusual that the financier also takes a mortgage over the aircraft governed by the foreign law (which is usually the law of the state of incorporation of the offshore owner).

Under Chinese law, the financial lessor can obtain the legal title to the leased property which serves as the security to the lessee's obligations under the financial lease.

i China's rights registration regime in asset finance

Aircraft

The following rights and security interest can be registered with the CAAC Rights Register:

- a owner's title to the aircraft;
- b mortgagee's mortgage right to the aircraft;
- c priority right to the aircraft;⁹ and
- d lessee's possessory right to the aircraft under a lease duration of which is no less than six months.

According to the Civil Aviation Law, it is not mandatory requirement to register the title of, mortgage or possessory right in a civil aircraft with CAAC Right Register but without such registration, the title, mortgage or possessory right have no legal effect against other *bona fide* third parties; and without registration with CAAC Right Register, the relevant party's priority right shall terminate on the date falling three months after the occurrence of the event out of which such priority right arose.

The priority rights to a civil aircraft shall have priority over the security interest in the civil aircraft in relation to compensation concerning such civil aircraft.

After the Cape Town Convention took effect in China, CAAC Rights Register and the International Registry function in parallel. Filing with the International Registry is a must if the creditor wishes to retain its priority under the Cape Town Convention and the registration with CAAC is necessary to preserve its priority under Chinese domestic security law.

8 'Mortgage', according to Article 33 of the Security Law of China, means, the obligor or a third person secures the performance of an obligation by property without handing over possession thereof and upon failure of the obligor to perform the obligation that the mortgage secures.

9 Article 19 of the Aviation Law provides that the following creditor's rights have priority over those of a mortgagee of a civil aircraft: (1) the reward for rescuing the civil aircraft (this refers to salvage awards); and (2) the necessary fees for safekeeping the civil aircraft (this refers to costs of necessary repair, maintenance and so forth).

Shipping

The following rights and security interest can be registered in the register book maintained by the MSA:

- a* the owner's title to a completed vessel or a vessel under construction, and, if applied by the owner, the vessel's funnel mark or house flag;
- b* mortgagee's mortgage right to the vessel; and
- c* bareboat charter.

According to the Regulations on Vessel Registration of China and the rules issued by the MSA, it is not mandatory requirement to register the title of or the mortgage right in a vessel with the MSA but without such registration, the title or mortgage rights have no force against other *bona fide* third parties. It is a mandatory requirement to register the bareboat charter if the bareboat charter is related to (1) a domestic charterer chartering a Chinese-flagged vessel, or (2) a domestic charterer chartering a foreign-flagged vessel, or (3) a foreign charterer chartering a Chinese-flagged vessel. During the period of the charter, the charterer cannot register the re-letting of the vessel without the prior consent of the vessel owner. Additionally, the mortgage rights over a vessel under a registered bareboat charter can only be registered if the registered charterer's consent has been obtained.

As to the international conventions on the property rights and the security interests, China has signed the International Convention on Maritime Lease and Mortgages on 18 August 1994. However, this Convention has not been ratified yet and is not effective in China.

Rail

China does not maintain a register of title or other rights in respect of rolling stock. The mortgage over rail stock is treated as a mortgage over moveables.

The mortgage over movables can be registered with the local office of the State Administration of industry and Commerce (which maintains the company registry in China) where the mortgagor is registered.

iii Financing of contracts

Aircraft

In China's market, the financiers of Chinese airlines include ECAs, Chinese banks (including both commercial banks and policy banks), foreign commercial banks, Chinese lessors (including both CBRC-regulated financial leasing companies and the MOFCOM-regulated leasing companies) and foreign lessors. The financing may take the form of direct lending, financial leases, operating leases, ECA financings and other structured financings.

The typical security package to the financier of the aircraft may consist of: (1) mortgage over the aircraft, (2) assignment of insurances, (3) airframe and engine warranties assignments, (4) assignment of lease agreement, (5) pledge over receivables in respect of the aircraft, (6) guarantee from the parent company, (7) escrow and pledge over the relevant bank accounts and (8) pledge over the equity of the special purpose project company.

Shipping

Chinese law permits a mortgage over a ship under construction. A Chinese shipbuilder may mortgage its ship under construction to a financial institution in China to obtain finance, and such mortgage can be registered with MSA's ship register. The shipowners are not allowed to mortgage the ship under construction yet.

Normally, the account bank of the Chinese shipbuilder can issue a pre-delivery payments refund guarantee in favour of the shipowner, and the shipowner can assign such guarantee together with its interests and rights under the shipbuilding contract to its financier as security of the PDP finance.

The typical security to the financier of the ship may consist of: (1) mortgage over the ship, (2) the general pledge and assignment of insurances, ship charters and etc., and (3) pledge over receivables in respect of the ship.

Rail

Typically, CRC will contract with the rolling stock manufacturers for purchase and finance the purchase of rolling stock through its financiers.

v Enforcement

The PRC law does not expressly accept 'self-help' remedies or equivalent concepts. However, if the debtor or mortgagor does not cooperate, the creditor may have to enforce its rights through legal actions of the court.

The mortgage agreement can provide for the circumstances in which the mortgage may be enforced and contractual rights that the mortgagee may have upon enforcement. The typical trigger events that would result in enforcement of the mortgage include the failure to pay any amount due under the financing or the occurrence and continuance of other event of default.

In addition to the mortgagee's contractual enforcement rights under the mortgage agreement, the Security Law of China and the Property Law of China also provide for certain statutory rights for the mortgagee to enforce the mortgage, which include the auction of the mortgaged property, the transfer of the ownership of the mortgaged property to the mortgagee with consent of the mortgagor after the enforcement to satisfy the debt, and the private sale of the mortgaged property with consent of the mortgagor. Under Chinese law, it is not lawful to set forth in the mortgage agreement that the mortgagee can foreclose the mortgaged directly upon enforcement.

vi Arrest and judicial sale

Arrest

Under Chinese law, a creditor may petition to the competent Chinese court to arrest the aircraft, ship or the rolling stock upon enforcement:

- a* either before the litigation, if the creditor can show to the court that the circumstances are urgent and the creditor's lawful rights and interests will suffer un-remediable harms without immediate preservation of the aircraft, ship or rolling stock; or
- b* during the litigation process, if the creditor can show to the court that without arrest of the aircraft, ship or rolling stock, it will be impossible or difficult to enforce the subsequent court judgment or order or will cause other damages to the creditor because of the actions of the mortgagor or other reasons.

If the petition is raised before the litigation, the creditor shall provide security, or the court will reject the petition.

If the action is brought up against the mortgagor in a foreign court rather than a Chinese court, it would be very difficult for the Chinese court to order asset preservation against the mortgaged property in China.

It is worth to note that the arrest of the ships is not dealt with by the ordinary people's court in China, but be subject to the jurisdiction of a maritime court of China (which is a special type of court formed to hear maritime litigations).

vii Judicial sale

If the debtor is not cooperative upon enforcement, the creditor may sue the debtor and petition to the court to enforce its rights. Set out below is a general description of the typical civil litigation procedures in China.

A bill of complaint is submitted to the appropriate court, setting forth the name and address of the defendant, the claim and the facts and legal bases of the case and the evidence that will support it. The Chinese court in the location of the domicile of the defendant, the place where the contract is performed, or the place chose by the parties through written agreement and has actual connections with the dispute would have jurisdiction.

If the Chinese court finds the bill of complaint acceptable (within seven days), it will file the case and will send a copy of the bill of complaint to the defendant (within five days from such filing). For the party that files the lawsuit, a court fee will be payable as well as the usual litigation costs.

The defendant should file a bill of defence with the court (within 15 days). However, failure by the defendant to file a bill of defence shall not affect the hearing of the case by the court.

After the court determines the date of trial, a trial will be held and a judgment rendered (within an extendable six-month period), although appeals to higher courts are permitted.

With the enforcement of General Provisions of the Civil Law since 1 October 2017, the general period of limitation of actions on a request to the Chinese court for the protection of civil rights is three years, such period being calculated from the time it was known, or should have been known, that a right was infringed upon. If more than 20 years have passed since the date of the infringement of the right, the Chinese court shall offer no protection.

In addition to the above, parties to a dispute may reach a settlement agreement at any time before judgment (therefore, a court approved mediation settlement is permitted to be entered into between a foreign lessor and a Chinese airline). If a settlement agreement is reached, the court will draw up a mediation decision. If a judgment or mediation decision requires enforcement, additional court fees as well as actual expenses for enforcement must be paid by the party seeking enforcement.

To facilitate enforcement of security interest and improve protection of the creditor, the Civil Procedure Law of China (Civil Procedure Law) also provides for a fast track procedure for enforcement of security interest. According to the Section 7 of Chapter 15 of the Civil Procedure Law, provided that there is no substantive dispute, the holder of the security interest may petition to the court for auction or sale of the property subject to the security interest. In this fast-track procedure, the court would review and determine whether the conditions for enforcement of the security have been satisfied and if they have, the court will make an enforcement order within 30 days.

As to those security documents that are submitted to the jurisdiction of foreign court, in the event that a final and conclusive judgment is obtained from the foreign court, such judgment can be recognised and enforced in China without re-examination or re-litigation on the subject matter thereof, if the following conditions are met:

- a* the judgment is made by a foreign court with competent jurisdiction and is final and conclusive;
- b* the jurisdiction of the foreign court is not precluded by any law, order or treaty;
- c* service of process for any proceeding against China party in the jurisdiction of the competent court has been lawfully effected on China party (other than by public notice), or the Chinese party has appeared and responded on the merits of the case in the relevant proceedings without receiving service thereof;
- d* the court of China is satisfied that the judgment neither contradicts the basic principles of the laws of China nor violates China's state sovereignty, security and public interest; and
- e* judgments of Chinese courts receive reciprocal treatment in the jurisdiction of the foreign court; as a matter of PRC law, this means that there exists a bilateral or multilateral treaty concluded or acceded to by China and the jurisdiction of the foreign court as to the mutual recognition and enforcement of judgments. To date, there has been no bilateral or multilateral treaty between China and the United Kingdom or United States in connection with the recognition or enforcement of court judgments; therefore, the judgments made by US or UK courts cannot be enforced in China directly.

V CURRENT DEVELOPMENTS

i Recent cases

Aircraft

The precedent case in repossession and enforcement against civil aircraft is rare in China's record. The bankruptcy of Dongxing Airline after the financial crisis in 2008 and the repossession of the aircraft leased to Dongxing by GECAS has been an important case that tested Chinese laws for a foreign operating lessor to repossess its aircraft.

Shipping

A recent case is the arrest of a ship named *MVAmin2*. Due to a dispute in respect of a loan to ISIM Amin Limited, and a mortgage over the *MVAmin2* provided thereto and in which ISIM Amin Limited transferred the *MVAmin2* to Shokooh Sahar Kish Shipping Co without the permission of the lender, the lender, which is DVB Bank SE, filed an application with Xia Men Maritime Court for arresting the *MVAmin2* before litigation. Xia Men Maritime Court ruled to permit such pre-litigation property preservation claim. During the litigation, the Xia Men Maritime Court putted the *MVAmin2* into judicial sale upon application of DVB Bank SE for ISIM Amin Limited's failure of providing guarantee. After the judicial sale, parties reached a mediation agreement and the relevant judicial procedures carried out in other countries were ceased or withdrawn. In this case, all the parties are foreign legal entities and the case facts took place abroad, however, the plaintiff voluntarily selected a Chinese court to resolve the dispute, which fully reflects the international credibility of China's maritime justice.

ii Developments in policy and legislation

To boost its economy, China aims to cut its overall tax burden of the enterprises and has continued to reform its turnover tax system. One development worth noting is the further reform of China's value-added tax policies, particularly on deduction of the value-added tax on the interest paid by a Chinese debtor to the financial institutions from its overall value added tax payable, and the share of value-added tax revenue between the central government and the local government that may affect the fiscal incentives provided by the local government to attract financiers in the transport finance industry.

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