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SUPREME PEOPLE'S COURT AFFIRMS VALIDITY OF INTERCOMPANY LOANS

BACKGROUND

New private lending rules that went into effect on 1 September 2015 will permit companies in China to borrow from each other. The Provisions on Certain Issues regarding the Application of Law in Trials of Private Lending Cases (最高人民法院关于审理民间借贷案件适用法律若干问题的规定, Fa Shi [2015] No. 18), issued by the Supreme People's Court on 6 August 2015 (the "Provisions"), recognize for the first time the legality of intercompany loans and more generally provide a legal framework for private lending within the People's Republic of China ("PRC").

ANALYSIS

I. Intercompany loans

The Provisions define "private lending" as lending activities between individuals, legal persons and/or other non-financial entities. This definition notably excludes lending activities involving financial institutions, but includes for the first time lending activities between companies that are not financial institutions. In line with this definition, the Provisions further provide in their Article 11 that, subject to some limited exceptions, courts must recognise as valid intercompany loans entered into between companies for the needs of production or business operations.

Such recognition of intercompany loans is a major development in the PRC, as since 1996, non-financial institutions have been banned from extending loans to affiliates or third parties, with or without interest, under the General Rules for Loans (贷款通则) promulgated by the People's Bank of China. In a reply issued 23 September 1996, the Supreme People's Court confirmed that intercompany loan agreements were null and void because they constituted a violation of financial laws and regulations. As a result and in practice, companies turned to entrusted loans to borrow from each other. Such entrusted loan arrangement required the lending company to deposit the loan amount with a bank, which would extend the same amount as a loan to the borrower company and charge a fee.

After the Supreme People's Court overruled its interpretation of validity of intercompany loan through the promulgation of the Provisions, PRC companies may legally conclude loan agreements for production or business operation purposes. However, the validity of an intercompany loan may still be challenged if the lending company regularly conducts lending business or its lending activities become its primary business, as such loans would no longer be made for production or business operation purposes.

II. Invalid private loans

The Provisions also clarify when a private loan should be held invalid:

- a) The lender uses funds borrowed from a financial institution for on-lending to a borrower at an excessive interest rate, and the borrower has or should have knowledge of such arrangement;
- b) A lender uses funds borrowed from another company or its employees for on-lending to a borrower for profit-making purposes, and the borrower has or should have knowledge of such arrangement;
- c) A lender offers a loan to a borrower for financing illegal or criminal activities, and the lender has or should have knowledge that the borrower will use the funds for illegal or criminal activities;
- d) The loan is made in contravention of public order and good custom; or
- e) The loan breaches any law or mandatory provision of regulations.

Scenarios (c) to (e) are in line with Article 52 of the Contract Law, which lists the circumstances in which a contract is invalid.

III. Interest rates

The Provisions also provide a legal framework for interest rates for private loans. Annual interest rates not exceeding 24% are legal and valid as long as they are agreed by the lender and borrower. The lender may request the borrower to pay interest according to the agreed interest rate.

If the annual interest rate exceeds 36%, the portion exceeding 36% is invalid, even if the rate was agreed by the lender and borrower. The borrower may request by action the lender to refund any interest already paid that exceeds the annual interest rate of 36%.

Loans with an annual interest rate between 24% and 36% agreed by the lender and borrower are considered a "natural obligation", which cannot be enforced by action. As such, if the borrower has already paid any interest, he may not be able to demand it back by action.

COMMENTS

These Provisions have been promulgated in a context where many small and medium-sized companies in the PRC are seeking financing solutions other than bank loans. They constitute an important step in the PRC by providing basic rules for private lending and reducing uncertainty for private loan lenders and borrowers. With a clearer legal framework, PRC companies now have more flexibility in managing their cash flow and capital structure.

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