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Is the Contractor More Secure with a Priority Right? A Functional Analysis of Article 286 of PRC Contract Law (English version)

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Is the Contractor More Secure with a Priority Right?

A Functional Analysis of Article 286 of PRC Contract Law *

Wei ZHANG

I. INTRODUCTION

A. Background and the Establishment of PRC Contract Law Article 286

In recent years, China's economic boom has drawn considerable attention all around the world. Real estate development is among the strongest pillars that support the fast growing GDP of this country. When fascinated by the shining residential buildings, office towers and public facilities sprouting across the country, however, we are also surprised at the mountains of the outstanding debts that Chinese contractors are not able to collect. Statistics shows that the aggregate amount of overdue payment to contractors has increased steadily during the past 15 years nationwide, with about \$440 million in 1990, \$2.4 billion in 1992, \$3.7 billion in 1993 and \$7.3 billion in 1995.¹ As of 2004, that number climbed to a record \$45 billion.²

* I owe my thanks to Kuang Duan (Fudan University Law School), Xiumin Qin (Tianjin Dagang District People's Court), Jian Zhang (Fujian Jun Li Law Firm, Beijing Office), Yunwei Chen (Shanghai Zhu Le Construction Development Company), Junhua Miao (Bank of Communications, Shanghai Branch), Hao Kuang (Beijing Gong He Law Firm, Shanghai Office) and Yawei Liu (Hao Ying Law Firm), for their assistance in collecting materials of this paper. I am also indebted to Howard Y. Yang (Debevoise & Plimpton LLP, New York Office), for proofreading as well as his insightful comments.

¹ Yibing Wang, *Lun Jian Zhu Gong Cheng Cheng Bao Ren De Fa Ding Di Ya Quan* [On the Construction Contractor's Statutory Mortgage], 11 Dang Dai Fa Xue [Modern Legal Science] 139, 139 (2002).

² Xinhua News Agency, *Quan Guo Tuo Qian Gong Cheng Kuan 3660 Yi; Ming Nian Nian Di Qian Wan Cheng Qing Qian* [The Defaulted Construction Price Totals to 366 Billion RMB Yuan Throughout the Country; Collection to Be Finished by the End of Next Year] (Aug 24th, 2004), at <http://news.cq.soufun.com/2004-08-27/315846.htm>.

Burdened with this huge sum of overdue payments, contractors are forced to delay the payment of wages to their employees, especially those who are physically involved in the construction work. The bulk of labor force in Chinese construction market comes from the nation's vast countryside that is still lagging behind in economic development. To most laborers from these areas, wages earned from construction work is the main, if not the sole, financial source to support their life and family. Thus, owners' default in payment to contractors, leading to the nonpayment of wages to construction workers, raises serious social problems regarding protection of the vulnerable laborers, and even deepens the imbalance of development between urban and suburban areas.

Against such a social background, legislators added an article into the new PRC Contract Law promulgated in 1999 (hereafter, the "Article 286"), which states:

If the owner fails to pay the contract price as agreed, the contractor may demand that the owner pay within a reasonable period of time. If the owner fails to pay by the expiration of the time period, the contractor may reach an agreement with the owner to convert the project into its monetary value or he may apply to a people's court to have the project auctioned off according to law, unless, in light of the nature of the construction project, it is not suited to being converted into its monetary value or auctioned off. The price for the construction project shall be, on a priority basis, offset against the monetary value into which the project is converted, or paid from the proceeds of the auction.³

³ The Contract Law of the People's Republic of China, art. 286. The translation is based on Vol. 13 No. 4 China Law and Practice 19, 59 (1999), with minor variations. The counter-party of contractor in a construction contract is sometimes referred to as "employer" in English legal literature (and is so translated in

Obviously, the law wants to provide the contractor with a statutory lien with which the contract price can be secured. In case of the owner's default, the contractor may credit the sale proceeds of the construction project against the amount owed to him.

B. Disputes about the Nature of Article 286

Soon after this article came into effect, a heated dispute arose regarding the nature of the right so created. In brief, there are three major theories among commentators: possessory lien,⁴ priority right⁵ and statutory mortgage.⁶

Under the possessory lien theory, the lien-holder is entitled to sell the collateral to recover his credit when the debtor fails to pay the contract price upon the lien-holder's demand. Possessory lien exists only when the lien-holder takes possession of the collateral and according to PRC Secured Transaction Law, the eligible collateral for possessory lien is limited to personal properties.⁷

The concepts of priority right and statutory mortgage do not exist in current PRC Secured Transaction Law. In fact, these two rights are very similar to each other. Both of them are

China Law and Practice). To avoid the possible confusion with the employment relationship between the contractor, as an employer, and his employees, I use the word "owner" instead. But it should be noted that not all those who contract with contractor for construction work are literally owners of the construction projects.

⁴ See, e.g., Ping Jiang, *Zhong Hua Ren Min Gong He Guo He Tong Fa Jing Jie* [A Brief Explanation to the Contract Law of the People's Republic of China] 223 (1999); see also Xiangjun Kong, *He Tong Fa Jiao Cheng* [A Textbook on Contract Law] 618 (1999).

⁵ See, e.g., Jianyuan Cui and Shiyuan Han, *Xin He Tong Fa Yuan Li Yu An Li Ping Xi* [The Principle of the New Contract Law and Case Analysis] 1220 (1999).

⁶ See, e.g., Huixing Liang, *He Tong Fa Di 286 Tiao De Quan Li Xing Zhi Yu Shi Yong* [The Nature and Application of the Right Stipulated by Contract Law Article 286], 19 *Min Shang Fa Lun Cong* [Civil and Commercial Law Review] 375, 375 (2001).

⁷ The Secured Transaction Law of the People's Republic of China, art 82.

generally considered as senior rights as compared to *consensual* mortgages in allocation of proceeds of foreclosure sale. Also, it is not necessary to hold possession of the collateral in order to enforce either right. To a large extent, these two rights are no more than different names of essentially the same thing. In Germany and Taiwan, where the priority right system is generally abolished in the civil code, the term of “statutory mortgage” is used, while in Japan, where the priority right system survived, this new term seems unnecessary.⁸ Moreover, in many construction situations, as the contractor usually takes possession of the project during the construction process and will possibly keep possession even after that (if the owner fails to pay the price), even the concept of possessory lien is not materially different from the other two. It seems that these disputes are of little practical significance. Therefore, in this paper I will call such right as the contractor’s priority right.

Aside from the above theoretic disputes, another problem, maybe of more practical importance, bewildered the judges and lawyers: Does the contractor’s priority right prevail over the previously perfected mortgages? Courts split on this issue. Some held the priority right superior to the mortgage,⁹ some concluded in the opposite way while still others tried to leave Article 286 “dormant”.¹⁰ As shown in the proceeding paragraph, those commentators who take the views of priority right and statutory mortgage agree that mortgages, even perfected earlier,

⁸ Germany, Taiwan and Japan are the other 3 jurisdictions with similar institutions that presumably influenced the draft of Article 286.

⁹ See, e.g. Fujian No.1 Construction Project Corp. v. Sanya Haisheng Construction Corp. Ltd. (Sanya Intermediate People’s Court, June 29th, 2000), at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=fnl&Gid=117448430>.

¹⁰ See generally Shuying Zhu, *Zhi De Zhong Shi De Zhi Fa Pian Cha* [A Note-Worthy Deviation in Law Enforcement] 10 *Zhong Guo Lü Shi* [Chinese Lawyer] 46 (2001).

should be subordinate to the right created under Article 286.¹¹ Yet these academic opinions are of no binding effects, though some of the commentators are those who actually drafted the article.¹² The law itself does not mention anything about the priority rank between this right and previously established mortgages. It does say that “the price of construction project shall be paid on a priority basis”, but that might as well mean the contractor should be paid just prior to unsecured creditors or later perfected mortgagees.

C. Interpretation of the PRC Supreme People’s Court

To address the priority problem, as well as some other practical issues, the PRC Supreme People’s Court interpreted Article 286 in its reply to a request for instruction from Shanghai High People’s Court. This reply was promulgated through the Supreme People’s Court’s official bulletin in June 2002 and thus became a formal judicial interpretation (hereafter, the “Supreme Court Interpretation”).¹³ It provides the following:

- (1) When adjudicating real estate disputes and dealing with execution affairs thereof, the people’s court should regard the contractor’s priority right as superior to mortgage rights and other credits, in accordance to Article 286 of PRC Contract Law.
- (2) If the consumer has paid the whole or the majority of the purchase price for the residential real properties, the contractor cannot claim his priority right on such properties against the consumer thereafter.

¹¹ Cui and Han, *supra* note 5, at 1220; Liang, *supra* note 6, at 378.

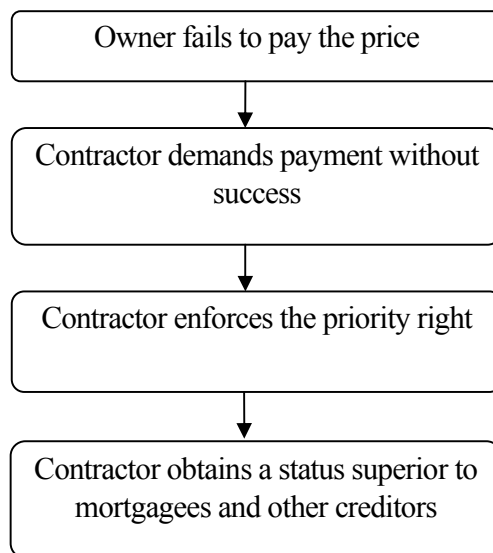
¹² Professor Huixing Liang is one of the leading drafters of the PRC Contract law.

¹³ In current Chinese judicial system, the official interpretation of the PRC Supreme People’s Court bears practically the same legal effect as the law enacted by the legislature.

(3) The construction price includes remunerations of employees, material costs and such other expenses that the contractor actually paid for the construction work. But the contractor's damages resulting from owner's breach should not be included.

(4) The statute of limitations of the priority right is 6 months, running from the date of the completion of the construction work or the completion date as stipulated in the construction contract. ...

Supplemented by this interpretation, the law has become somehow clearer. In brief, Article 286 is supposed to work as follows:



Note that there exist several exceptions. First, certain construction projects cannot be sold or otherwise converted into monetary value. Second, the contractor may still be subordinate to consumers purchasing the residential units.

D. Purpose and Structure of This Paper

The purpose of this paper is both positive and normative. The positive study

investigates the actual operation and predicts the potential functions of the contractor's priority right, while the normative one aims at policy suggestions that calls for certain amendments to the current law. To achieve these goals, I will focus on three entities involved in the operation of Article 286 – the court, the bank and the contractor.¹⁴

In section II, I will explore the application of the contractor's priority right under current legal and social circumstances. This study shows that Article 286 may not do so much good to contractors as legislators expected. Section III first examines traditional arguments for the contractor's priority right and then provides my own justification on the cost-benefit basis. Finally, this section proposes several improvements to better exploit the potential benefits of the contractor's priority right.

Due to limitations of the resources at hand, my analysis depends heavily on secondary materials. The conclusions reached in this paper are to be tested by further empirical studies.

II. A FUNCTIONAL ANALYSIS

A. Courts' Understanding of the Law

How does the court understand Article 286? The answer to this question is the starting point for a functional analysis of this article. Courts' understanding, if known to the relevant parties, will directly affect their decision-making in practice. Many conducts of the parties can be regarded as responses to courts', rather than legislators', positions. These positions may shed

¹⁴ This approach is largely influenced by Lynn M. LoPucki, *The Systems Approach to Law*, 82 Cornell L. Rev. 479 (1997).

much light on the parties' incentives behind their choices.

However, the reported, or even adjudicated, cases on this topic are very limited in number. Due to this limitation, it is impossible to explore the judicial understanding in every detail. Therefore, in this section, I will trace the judicial understanding merely in two broad aspects, which appear to be prevalent among the courts and perhaps also influential upon the parties' incentives.

1. *Objective of the Article*

It seems that, in the courts' point of view, the main objective of Article 286 is to protect the construction laborers by securing the payment of their wages. One court directly related this article to the protection of basic human rights and regarded it as "based on the considerateness to the right of existence, recognizing its superior status to other rights, which is in accordance with the fundamental requirement of human rights protection".¹⁵ Another court stated in its opinion that the "*more* important reason for the contractor's priority right, other than securing the contractor's credit of construction price, relies on the fact that the construction project entails the *labor value* of construction workers ..." (emphasis added).¹⁶

As the Supreme Court Interpretation shows, the construction price secured by the priority right includes two parts. One is the employees' remuneration (essentially, laborers' wages) and the other is the actual expenses of the construction work advanced by the contractor for the owner.

¹⁵ Chongqing No.1 Intermediate People's Court, *Jian Zhu Gong Cheng You Xian Shou Chang Quan Fa Lü Shi Yong Yi Jian Tao Lun Hui Hui Yi Ji Yao* [Memorandum on the Conference of Legal Application of the Contractor's Priority Right] 1 (Feb. 2004) (unpublished manuscript).

¹⁶ Nantong Construction Project General Contracting Corp. Hainan Company v. Hainan Guo Ji Mao Yi Mansion Corp. Ltd. (Haikou Intermediate People's Court, Dec. 18th, 2001), at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=fnl&Gid=117448278>.

However, these two parts do not represent the whole construction “price” as Article 286 itself provided. In construction practice, such price is calculated differently. Usually, it consists of four parts: direct fees, indirect fees, profit and tax. The first two stand for the cost of construction work.¹⁷ The scope set by the Supreme Court Interpretation roughly covers the direct fees and indirect fees, but the profit and tax are puzzlingly left unprotected. Taking account of courts’ above understanding of the objective of the article, the puzzle might be explained in this way: Since the contractor’s priority right is deemed to focus on laborer-protection rather than contractor-protection, the contractor’s other stakes in the construction contract become less important once the employees’ remuneration is fully protected. As to the actual expenses, they might become the most *apparent* competing interests to the employees’ wages for the construction price to be paid by the owner, thus can’t be easily neglected without sacrificing the potential to protect the construction laborers.

Given the background against which Article 286 of PRC Contract was established, the court’s view is quite understandable. However, it is unclear whether that is consistent with the legislators’ objective when drafting the law. Although we can reasonably surmise that the same consideration might exist in legislators’ minds because they are facing the same social background as judges, no direct evidence was discovered to support such a legislative objective in some semi-official legislative interpretations¹⁸ published soon after the establishment of the Contract

¹⁷ Jian She Gong Cheng Shi Gong Fa Bao Yu Cheng Bao Ji Jia Guan Li Ban Fa [Administrative Measures on Price Calculation of Ordering and Contracting of Construction Projects], art. 5; *see also* Jiandong Wang, *Ping He Tong Fa Di 286 Tiao* [Some Comments on Article 286 of PRC Contract Law], 2 *Zhong Guo Fa Xue* [Chinese Legal Science] 63, 65 (2003).

¹⁸ The official legislative interpretation of law, according to the PRC Constitution, must be enacted as an act by the Standing Committee of National People’s Congress, which happens in relatively few occasions. In

Law. In the two available versions of interpretations to PRC Contract Law edited by the Commission of Legislative Affairs of the Standing Committee of the National People's Congress, Article 286 is said to be “for the purpose of protecting the realization of *contractor's price credit* ...” (emphasis added).¹⁹ For a functional analysis, the inquiry is less important whether the judicial understanding is compatible with the legislative objective. Yet the actual effect of Article 286 may possibly fluctuate with the weight shifted from contractor-protection to laborer-protection. This point will be further elaborated below in this paper.

2. *Implementation of the Contractor's Priority Right*

When and how will the court implement the priority right provided by Article 286? Two tentative conclusions might be drawn from the relevant materials.

First, it seems that the plaintiff must claim the contractor's priority right in her suit; otherwise the court may not voluntarily apply this rule. In other words, if the plaintiff merely sues for the construction prices in default but does not allege that these prices should be secured by the contractor's priority right on a specific construction project, the court will only award such prices without enforcing the priority right. I have collected 5 case reports citing PRC Contract Law Article 286, and the contractor's priority right was actually applied in 3 of them. The

practice, the interpretation made by the Commission of Legislative Affairs can be deemed as a semi-official legislative interpretation since this commission is the working department of the Standing Committee in charge of the drafting of laws.

¹⁹ The Commission of Legislative Affairs of the Standing Committee of National People's Congress, Research Office (hereafter, Research Office), *Zhong Hua Ren Min Gong He Guo He Tong Fa Shi Yi* [Explanation to PRC Contract Law] 421 (1999); *see also* Kangsheng Hu, *Zhong Hua Ren Min Gong He Guo He Tong Fa Shi Yi* [Explanation to PRC Contract Law] 439 (1999). Kangsheng Hu, current director, served as the vice director of the Commission of Legislative Affairs when the PRC Contract was passed.

plaintiff positively claimed her priority right in all these 3 cases.²⁰ Nonetheless, in another case, as introduced in an article written by a judge, the plaintiff merely claimed the outstanding construction price and the court awarded accordingly, without mentioning the application of the contractor's priority right.²¹

Second, although Article 286 affirmatively manifested that the contractor, to enforce the priority right, "may apply to a people's court to have the project auctioned off", yet in practice courts do not allow the contractor to apply directly for auction without first bringing a suit about the owner's default on paying the price. In other words, the contractor must get a judgment against the owner for the construction prices owed before commencing an execution proceeding to enforce his priority right. A district court judge said during my interview with her, "I have asked judges in several other places. It seems to me that a direct application for executing (the priority right provided by) Article 286 (merely with a construction contract) is not permitted in various places".²² This point is further proved by other references.²³

The inconsistency between the procedural law and the substantive law is said to be the

²⁰ See cases in *supra* note 9, note 16 and Wuhan Geological Probing Foundation Project Corp., Hainan Branch v. Sanya Oriental Business Stock Corp. (Sanya Intermediate People's Court, Aug. 23rd, 2000), at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=fnl&Gid=117448425>.

²¹ See Youhuan Zeng, *Ben An Jian She Gong Cheng Kuan You Xian Quan Ying Ru He Ti Xian?* [How Should the Contractor's Priority Right Be Reflected in This Case?] 9 Fa Ting [The Court] (2003), at <http://www.fszjfy.gov.cn/shownews.asp?newsid=2043>. The author is the Vice President of Foshan Intermediate People's Court.

²² Telephone interview with Xiumin Qin, Judge, Tianjin Dagang District People's Court (Nov. 4, 2004).

²³ See, e.g. Rong Ma, *Lun Jian She Gong Cheng Jia Kuan You Xian Shou Chang Quan De Quan Li Shu Xing Ji Qi Zai Si Fa Shi Jian Zhong De Shi Yong* [On the Nature of the Contractor's Priority Right and Its Application in Judicial Practice], at <http://www.jscourt.gov.cn/fykw/spyj/2002/10/10-06.htm>; Lianzhuan Yang, *Jian Du He Tong Fa 286 Tiao* [Understanding of PRC Contract Law Article 286], at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=art&Gid=335564575>; see also Zeng, *supra* note 21.

reason for such practice of the court. According to current procedural law, execution proceeding must be commenced with an enforceable judicial order, arbitration decision or obligation instrument certified by the notary public. Thus, even though the contractor is entitled, under the Contract Law, to apply simply for an auction of the construction project, the court will still find it groundless, under the procedural law, to foreclose and sell the collateral if the contractor does not have the above documents.²⁴ The substantive reason for the court's view, as it seems to me, exists in the concern with potential mistakes in stepping into execution directly. The trial proceeding, to a large degree, is used to guarantee that the substantive legal relationship between the contractor and the owner is as alleged by the contractor, and that the owner has exhausted all valid defenses against the contractor's claim. In short, it can only be determined through the trial proceeding whether a contractor's priority right is ripe for execution.

Courts' position on the implementation of the priority right may lead to the situation where the contractor has no chance to enforce his priority right at all if not claiming it in the first place. On the one hand, courts won't voluntarily implement the right if not required by the contractor in the trial proceeding, while on the other hand the contractor cannot turn to the execution proceeding either, even if he attempts to enforce his priority right after a judgment is reached without mentioning it. Moreover, the contractor may not be allowed to bring the case back to the trial court merely to add a claim for the priority right, because in a trial proceeding he must bring a suit against a *defendant* (i.e. the owner) and can't only require a declaratory judgment

²⁴ Yang, *supra* note 23, at 4.

for a right on certain *property*,²⁵ but such a suit will be declined under the doctrine of res judicata.²⁶

B. Banks' Reaction to the Law

1. Banks' Status Under the Law

To explore banks' reactions, we first need to understand the changes in their status since Article 286 and, especially, the Supreme Court Interpretation came into being.

In urban real estate development projects,²⁷ banks play a critical role in providing capitals. Most owners²⁸ raise fund through debt financing from banks. In practice, owners apply for construction loans from banks and set mortgages on the land use right (of the land on which the project is to be constructed), as well as the forthcoming construction project,²⁹ to secure the loans. In case that owners default on paying the loans, the banks, as the mortgagees, may sell

²⁵ The Civil Procedural Law of the People's Republic of China, art 108 (2).

²⁶ This situation is illustrated by a case introduced in Zeng, *supra* note 21.

²⁷ In this paper, "urban real estate development project (Cheng Shi Fang Di Chan Kai Fa)" refers to one major type of construction projects in China. According to Cheng Shi Fang Di Chan Kai Fa Jing Ying Guan Li Tiao Li [Administrative Regulation on Developing and Managing of Urban Real Estate Development Project], enacted by PRC Ministry of Development, developing and managing such projects is "an activity of constructing basic facilities and buildings in state-owned urban land, and transferring the development projects or selling, leasing residential properties." (art. 2) Actually, this is not a well-defined term yet frequently used in official as well as unofficial contexts. In essence, it is basically used to distinguish with the governmental development project. Urban real estate development projects are mainly financed through commercial capitals assembled by private developers. Such projects are mostly residential and commercial buildings. Developers transfer or lease the projects for profit. In contrast, governmental development projects are financed through governmental budgets. National or local governments act as the developer and the owner. The projects are usually for public use.

²⁸ Usually but not necessarily, owners are also developers.

²⁹ The yet-to-be-built project is allowed to be mortgaged by Cheng Shi Fang Di Chan Di Ya Guan Li Ban Fa [Administrative Measures on Mortgage of Urban Real Estate Development Project], art. 3 and Zui Gao Ren Min Fa Yuan Guan Yu Shi Yong "Zhong Hua Ren Min Gong He Guo Dan Bao Fa" Ruo Gan Wen Ti De Jie Shi [The Interpretation by the PRC Supreme People's Court About the Problems Pertaining to the Application of PRC Secured Transaction Law], art. 47.

the collaterals and use the proceeds to satisfy their loan credits. Moreover, as the bank is usually, if not always, the first creditor to set and perfect mortgage on urban real estate development projects and the incidental land use rights, before the appearance of Article 286 and the Supreme Court Interpretation, it will hold the first priority in the proceeds of sale under the “first in time, first in right” rule.³⁰

However, as stated above, the Supreme Court Interpretation permits the contractor to prevail over the bank in case of the owner’s default even if the contractor obtains the priority right after the bank became a mortgagee of the construction project and has never had the priority right perfected. Obviously, banks’ status becomes more fragile with the establishment of the contractor’s priority right in current law. The contractor does not need to record or otherwise perfect such right. Neither is he required to give any notice to the previous mortgagee, the bank, before enforcing his right. Therefore, unless investigating actively, the bank may be subordinate to the contractor even without knowledge. If the proceeds of sale are less than the total amount of the contractor’s and the bank’s credits, the bank will essentially become an unsecured or partially unsecured creditor.

Furthermore, if the owner and the contractor collude to defraud, the bank will confront even higher risks, and such collusion is relatively easy when the contractor is controlled by the owner or the contractor is essentially alter ego of the owner.³¹ The well-known “Cui Hu Shan

³⁰ The Secured Transaction Law of the People’s Republic of China, art. 54.

³¹ There seems to be some merits in tax for such an alter ego arrangement. See generally Xianfeng Zhou & Baizhou He, *Gong Cheng Kuan You Xian Shou Chang Quan Xiang Guan Ge Fang Quan Li De Fa Lü Di Wei* [The Legal Positions of the Parties Relevant to the Contractor’s Priority Right], 4 *Jian Zhu Jing Ji* [Construction Economy] 53, 54 (2004).

Zhuang” case, happening in Guangzhou, may serve as a good illustration of this kind of risk. Since the case was finally settled by arbitration, it has not been officially reported. As appeared in news stories, the owner in this case defaulted on paying the construction loan to the bank, so the bank prepared to sell part of the construction project, the collateral of mortgage, in order to collect its non-performing loan. Right after that, nonetheless, the contractor suddenly brought a suit against the owner for an alleged outstanding construction price. It appears that the owner’s indebtedness to the contractor as determined by the arbitration tribunal was higher than the value of the collateral and that the contractor enjoyed a priority right with respect to this amount. Thus, the bank, becoming a junior lien holder, lost the chance to collect its loan through judicial sale of the collateral. Collusion might be suggested in this case by the fact that the contractor did not claim his construction price during the 2 years’ period since the completion of the construction work, when the owner’s financial situation was good enough to pay this price.³² Similar cases are said to arise in other places as well.³³

2. *Potential Ways for Self-Protection*

Given the inferior status as described above, how can banks protect themselves? Here follows an analysis about the potential ways for banks’ self-protection. These measures might be

³² Wenqiang Zhang, *Cui Hu Shan Zhuang Shi Jian Diao Cha: Kai Fa Shang Cheng Jian Shang He Mou Yin Hang?* [Investigation of the Cui Hu Shan Zhuang Case: Collusion Between the Owner and the Contractor to Defraud the Bank?], 21 *Shi Ji Jing Ji Bao Dao* [21 Century Economy Reporter] (Jun. 21st, 2003), at <http://house.focus.cn/newshtml/47772.html>. Yet it is unclear how the contractor managed to overcome the 6-month requirement set by the Supreme Court Interpretation.

³³ See Yaming Gu, *Qian Xi Gong Cheng Jia Kuan You Xian Quan De Yin Hang Feng Xian Fang Fan Dui Ce* [A Preliminary Analysis to Banks’ Counter-Measures Against the Contractor’s Priority Right], 3 *Zhong Guo Fang Di Chan Jin Rong* [China Real Estate Finance] 25, 27 (2004) (A Nanjing case: contractors claiming priority right on unpaid construction price after the bank offsetting the construction loan with money in owner’s deposit account; the offset held to be invalid).

divided roughly into three categories.

The first category is composed of devices aiming at circumventing the contractor's priority right. The easiest way for circumvention is to require contractors' waiver. Banks may provide in the construction loan agreements that the owner should require contractors to waive their priority rights in the future construction project. Banks may also execute trilateral agreements with owners and contractors simultaneously, in which contractors promise a waiver. In current Chinese construction market, contractors are intensely competing for construction work while owners are generally short of construction funds. Banks, therefore, are in advantageous positions to bargain for contract clauses in their favor. It seems that some banks do take this approach to deal with the risks resulting from the contractor's priority right.³⁴ The dispute about the validity of such waiver, however, has not yet been settled. In other words, if the court interprets Article 286 as a mandatory, rather than default, rule which couldn't be changed by agreement, banks will still be subordinate to contractors. In an early draft of a judicial interpretation,³⁵ the Supreme Court explicitly permitted a prospective waiver clause. Yet given that the bank can easily get such a clause from the contractor, Article 286 will become practically useless, if the court sanctions a waiver. Conceivably out of this concern, the Supreme Court kept silent on this issue in the final version of its judicial interpretation promulgated recently. So the

³⁴ Zhou & He, *supra* note 31, at 55; *see also* Changhao Gu, *Jian She Gong Cheng Cheng Bao Kuan De You Xian Shou Chang Quan* [*On the Contractor's Priority Right*] 12 *Zheng Fu Fa Zhi Yan Jiu* [Governmental Legal Study] 1, 9 (2000); this is also verified by my telephone interview with Jian Zhang, lawyer and specialist in construction law, Fujian Jun Li Law Firm, Beijing Office (Feb. 7th, 2005).

³⁵ *Zui Gao Ren Min Fa Yuan Guan Yu Shen Li Jian She Gong Cheng Shi Gong He Tong Jiu Fen An Jian Shi Yong Fa Lü Ruo Gan Wen Ti De Jie Shi* (Zheng Qiu Yi Jian Gao) [The Interpretation by the PRC Supreme People's Court About the Problems Pertaining to the Adjudication of Construction Project Contract (Draft Soliciting Public Comments)] (hereafter, DSPC), art. 27.

bank still can't safely rely on the contractor's promise to waive the priority right.

The other way for circumvention which might be approached by the bank is to take advantage of the proceeds of sale in the owner's account. Normally, the bank financing the construction project requests the owner to open an account in the same bank and any proceeds of the project shall be put into this account. In case of the owner's default, the bank may use the money in this account to offset the loan credit. Under the current law, it is unclear whether the contractor's priority right may extend to the proceeds of the collateral. The bank, thus, can argue that the proceeds of the construction project are not covered by the priority right and can appropriately be used for offsetting. However, it is still possible that the court will invalidate this practice.³⁶

With respect to residential properties in particular, usually the bank that advanced construction loans will also finance purchasers to buy the properties. So banks can easily substitute the old construction loans with the new purchasing loans. At the same time, since purchasers will also mortgage the purchased properties to the bank, the bank is fully secured with respect to the second kind of loans. In addition, as the bank becomes a mortgagee of purchasers', rather than contractors' assets, its mortgage is not subordinate to the contractor's priority right any more.

The second category consists mainly of the defenses to be raised during litigation or execution proceedings. When the contractor files an action to collect the construction price and claim the priority right, the bank, as the mortgagee of the construction project, may require to be

³⁶ See, e.g. the case cited in Gu, *supra* note 33, at 27.

added as an “a third party with independent claims” in the litigation.³⁷ Since the bank is the owner’s creditor, according to PRC Contract Law Article 73, it can arguably claim the owner’s defenses, in subrogation, against the contractor. Defects and incompleteness of the construction project might be the most obvious defenses in this regard. Other defenses may challenge the scope of the construction price secured by the priority right (contractor’s profit is not covered, neither is his liability to third parties incidental to the construction work), or the scope of the collateral subject to such right (perhaps the land use right is not included).³⁸ But it seems that these defenses can do no more than adjourning the execution of the priority right, or decreasing the amount the contractor may collect from the proceeds of sale. And contractors can still claim the same right after repairing defects or completing construction projects.³⁹

In case that the contractor manages to enforce the priority right and auction off the construction project, the bank may also bid at the auction. However, since the bank’s security interest is subject to the contractor’s priority right, the bank cannot merely offset the sale’s price with its loan credit but has to pay the contractor with real money. In effect, the bank will buy out the priority right. But on the other hand, the bank can join in the bidding to prevent the project

³⁷ The Civil Procedural Law of the People’s Republic of China, art. 56. The bank may raise objections in the execution process (PRC Civil Procedural Law, art. 208).

³⁸ Yang Wei & Lihua Huang, *He Tong Fa Di 286 Tiao Dui Yin Hang Xing Shi Di Ya Quan De Ying Xiang* [The Influence of Contract Law Article 286 on Enforcement of the Bank’s Mortgage] 1 Hangzhou Jin Rong Yan Xiu Xue Yuan Xue Bao [Journal of ICBC Hangzhou Institute of Financial Managers] 46, 47 (2002).

³⁹ As Article 286 provided, the contractor can skip the auction process and merely “reach an agreement with” the owner “to convert the project into its monetary value”. When such value is unreasonably underestimated, perhaps due to conspiracy, the bank, again as the owner’s creditor, can arguably require the court to nullify the agreement between the contractor and the owner according to PRC Contract Law, art. 74. But the bank has to prove that the value is “obviously unreasonable” and that the contractor also “has knowledge of this situation” (in essence, conspiracy must be shown), which is deemed to be hard to satisfy in practice (see Zhou & He, *supra* note 31, at 55).

being sold at an unreasonably low price. Especially when the construction project, though potentially profitable if fully developed, is to be sold unfinished due to the owner's shortage of funds, it might be desirable for the bank to take over the project and provide new money for further development.

The third category is made up of various monitoring measures. To minimize risks associated with the construction loan, banks may carefully screen the owner before advancing the construction loan, intensively monitor his conducts (especially use of money) during the construction process, and call the loans promptly in case of any default. Actually, as the chief financier of the construction work, certain kind of monitoring is always supposed to be practiced by the bank, no matter whether the contractor's priority right exists or not. But it is said that banks are quite often neglectful of the monitoring task and excessively rely on mortgages for debt-collection.⁴⁰ With the establishment of the contractor's priority right, banks become less secure even under the protection of mortgages. And this change in status is expected to give the bank more incentive to practice monitoring.⁴¹ While a detailed positive study on the change of banks' monitoring incentive will be made in section III-B-2 below, it is intuitively true that more intensive monitoring would decrease the risks of construction loans, including those resulting from the contractor's priority right.

First of all, the bank may carefully select the owner and make loans only to those who

⁴⁰ See Changhao Gu, *Dui He Tong Fa Di 286 Tiao Si Fa Jie Shi De Ping Xi Yu Si Kao* [Comments and Reflections on the Judicial Interpretation to PRC Contract Law Article 286] 4 *Zheng Fu Fa Zhi Yan Jiu* [Governmental Studies on Law] 1, 4 (2002).

⁴¹ *Id.*

have a good potential in repaying all debts arising from the construction project. Presumably, banks can make such selection on two principle bases. First, they may investigate owners' background information, especially their financial situations and credit history. If the owner used to default in construction price or at the edge of insolvency, it might be very likely that the contractor will eventually enforce the priority right, thus the construction loan is subject to a high risk. Second, banks may lend money only to those owners who have already had certain percentage of the construction funds. In effect, this kind of requirement focuses on the owner's own stake at the construction project. The more money the owner takes out of his own pocket, the less likely he will take unreasonable risks in the project.⁴²

Indeed, banks are supposed to take these measures in selecting the potential borrowers. In 2003, the People's Bank of China requires that commercial banks should lend construction loans to those owners without a history of default in construction prices and with an equity capital no less than 30% of the total funds needed for the construction project.⁴³ In 2004, the PRC Banking Regulatory Commission also adopted similar regulations and further increased the equity capital requirement to 35%.⁴⁴ In practice, however, banks may have difficulty having access to

⁴² The risk alteration problem will be discussed in section III-B-1 below.

⁴³ The People's Bank of China, *Zhong Guo Ren Min Yin Hang Guan Yu Jin Yi Bu Jia Qiang Fang Di Chan Xin Dai Ye Wu Guan Li De Tong Zhi* [Circular on Further Strengthening the Management of Real Estate-Related Credit Businesses], art. 1. Some commentators believe that this circular was, at least in part, stimulated by the risks arising from the contractor's priority right (Zhou & He, *supra* note 31, at 54).

⁴⁴ PRC Banking Regulatory Commission, *Shang Ye Yin Hang Fang Di Chan Dai Kuan Feng Xian Guan Li Zhi Yin* [Guidelines on Risk Management by Commercial Banks Regarding Real Estate Loans], art.16. It is unclear whether these requirements are direct reactions to the contractor's priority right. Similar requirements seemingly existed even before the Supreme Court Interpretation which subordinates banks' mortgages to the priority right. However, it is still noticeable that both of the two

owners' background information. No well-established credit history reporting system exists in most places of the country. In addition, some owners are organized temporarily for the development of a specific project and may dissolve soon after the project is completed. In some places, Shanghai for example, the local government publishes periodically the name list of those owners with a bad history of default on construction prices.⁴⁵ Conceivably such information may help banks select owners when making loan decisions. Investigation is yet to be done as for the commercial bank's compliance with above regulations.

Second, banks may diligently monitor owners' usage of construction funds during the developing process. It appears that the loan agreement usually specifies the bank's right to check and monitor the usage of the loan, and may also entitle the bank to examine the debtor's accounting books as well as other financial records.⁴⁶ In addition, the PRC Banking Regulatory Commission also required commercial banks to set up a monitoring system and keep aware of any changes of the owner, contractor or the construction project.⁴⁷ Again it is unclear whether banks are exercising their monitoring rights effectively in reality. Some materials suggest that, at least before the appearance of Article 286, banks did poorly in monitoring the usage of construction

administrative entities in charge of the commercial banks reiterated these requirements in their recent regulations adopted after the Supreme Court Interpretation.

⁴⁵ Yi Zhang, *Shanghai Cong Yuan Tou Du Jue Gong Cheng Kuan Tuo Qian; Chou Jian Jian Zhu Min Gong Gong Zi Zhuan Hu* [Shanghai Preventing the Default on Construction Prices From the Origin; Preparing to Establish Special Accounts for Construction Workers' Remunerations] (Aug. 14th, 2004), at http://news.xinhuanet.com/newscenter/2004-08/14/content_1781708.htm (published originally in Jie Fang Ri Bao [Jie Fang Daily]).

⁴⁶ E.g. The Model Loan Contract of China Construction Bank, art. 5.

⁴⁷ *Supra* note 44, art. 20.

loans.⁴⁸

Furthermore, though construction loans advanced on term basis, these terms are not necessarily connected with the progress in construction work.⁴⁹ Some lawyers suggested that, in order to minimize the risks associated with the contractor's priority right, banks should condition each advance of the loan on the owners' timely payment of construction prices. But banks may deem such suggestion as impractical. It is said that banks "don't have effective methods at all to investigate whether (the owner) has defaulted in paying construction price" since "the value of the project under construction is changing all the time and banks have difficulty in keeping accurate track of the ever-changing construction price".⁵⁰ In practice, the price agreed in construction project contract is no more than an estimate. Thus, although the construction price is supposed to be paid to the contractor periodically during the construction process, such payment is also based on estimation. The real price cannot be settled until the final accounting which will be made after completion of the construction work.⁵¹ Put in another way, even if the owner made every periodic payment to the contractor in strict accordance to the contract, chances still exist that part of the construction price will be in default. Essentially, except that the loans were advanced after

⁴⁸ Gu, *supra* note 40, at 4.

⁴⁹ The Banking Regulatory Commission provides that "banks may advance construction loans on term basis according to the progress of the project" (*see supra* note 44, art. 20).

⁵⁰ Kunfeng Zhu, *Fang Dai Feng Xian Tu Xian Guangzhou Yin Hang Ye Dongguan Mi Shang Dui Ce* [*Risk in Construction Loans Increasing; Bankers in Guangzhou Discussing Measures to Cope at Dongguan*] (Jun. 17th, 2003), at http://news.xinhuanet.com/house/2003-06/17/content_923451.htm (originally published in *Jing Ji Guan Cha Bao* [Newspaper of Economic Observation]).

⁵¹ Telephone interview with Yunwei Chen, vice manger-in-chief, Shanghai Zhu Le Construction Development Company (Nov. 12th, 2004).

final accounting, banks could never be sure about whether default existed and the volume of indebtedness. But if so, construction loan wouldn't be necessary in the first place. In my opinion, however, conditioning the loan advance on owner's strict compliance with the payment clause in construction project contract may reasonably reduce these risks associated with the priority right, even if this cannot completely eliminate these risks. At least, noncompliance with the contract clause will be a good sign of increased risk and banks should take extra care before making further advances.

Finally, to ensure that the contractor is properly paid, thus lowering the probability of the enforcement of the contractor's priority right, banks may advance construction loans directly to the contractor instead of the owner.⁵² This can be seen as another way to monitor the usage of loans. In effect, it also means that the bank pays construction price instead of the owner. However, it seems that banks seldom resort to this monitoring method. The reason is said to exist partly in banks' contractual duties. It is the owner, not the contractor, who reached the loan agreement with the bank therefore the bank owes its duty of advancing loans to the owner.⁵³ Nevertheless, to overcome this hurdle, the bank may also have the owner promise in the loan contract that the advance can be made to the contractor. A more creditable explanation is that owners need to use the loan for other reasonable purposes apart from paying contractors. Given the current situations in Chinese construction market, however, such purposes are not so obvious. Since contractors not only provide working hands but also pay a substantial portion of material

⁵² A similar suggestion is made that the bank reaches loan agreement directly with the contractor and the owner serves as a guarantee (*supra* note 50).

⁵³ Telephone interview with Junhua Miao, Bank of Communications, Shanghai Branch (Mar. 2nd, 2005).

costs in advance for owners,⁵⁴ it appears that most of the construction loan would reach contractors sooner or later. Conceivably, there might be two other major expenses relevant to construction projects. The first is the price of land use right. As the owner is not allowed to apply for construction loans before obtaining the land use right, he must collect funds from other sources to pay this price. It is said that owners would borrow short term loans from other entities (e.g. overseas investors), or from banks but in other pretexts, to cover this price. Once the construction loan is approved by the bank, the owner will repay those short term loans with the new money provided by the bank.⁵⁵ The second expense which is not covered by the construction price is the cost for relocating the current residents. This usually is a substantial cost to the owner. In urban redevelopment projects, it is the municipal government that grants the land use right and charges the land use right fee. However, generally the government won't bear the financial burden to resettle the residents living on that land. So the owner must collect funds for these expenses as well. Is that the reason why banks do not advance loans to the contractor? Further investigation might be needed. Although banks rarely advance construction loans directly to contractors, some banks are said to request written acknowledgement by contractors before advancing loans to owners.⁵⁶ This condition plays more or less the same role as direct advance to contractors. It gives contractors notice that money is arriving. Above all, owners are more likely to pay contractors with construction loans in order to obtain their acknowledgement.

⁵⁴ Interview with Chen, *supra* note 51. See also Gu, *supra* note 34, at 8.

⁵⁵ Interview with Zhang, *supra* note 34.

⁵⁶ Telephone interview with Hao Kuang, attorney at law, Beijing Gong He Law Firm, Shanghai Office (Dec. 18th, 2004).

Among the above three categories, the first and the last seem to be substitutionary to each other while the second is supplementary, mainly, to the last one. If the bank can circumvent the priority right it need not take much trouble to monitor the owner. In contrast, if the effective monitoring is practical then the bank may cope with the risk associated with the priority right even without circumvention. In addition, when circumvention is allowed, the ex post litigation or execution strategies are likely to be unnecessary. In terms of monitoring, nevertheless, these strategies might be applicable when risk cannot be eliminated entirely. Predictably, banks will choose rationally among these potential methods based on cost-benefit considerations. As indicated above, under current market situations, the cost for circumvention is comparatively low. Moreover, circumventing methods can totally eliminate the risk arising from the priority right while monitoring usually cannot, thus may further involve costs for taking measures in the second category. Therefore, if the court makes favorable decisions on circumventing strategies, banks will do no more monitoring than they did before the adoption of the contractor's priority right.

Besides, interest will play its role as an implement to balance the loan risk as usual. With the increased risk, the interest rate of the construction loan is expected to rise accordingly and any monitoring cost or other transaction costs will also be reflected in the interest rate. In this sense, circumventing measures, if allowed, is more desirable than monitoring measures even to the owner. When banks cannot effectively raise the interest rate high enough to cover the risk as well as other costs, due to state regulations or market competition perhaps, they will choose to step out of the construction loan market, as reported by some writers.⁵⁷

⁵⁷ Gu, *supra* note 33, at 27.

C. Problems Confronted by the Contractor

The legal design of the priority right will directly affect contractors' incentive to enforce the right. In addition, courts' positions on application of the law and banks' reactions to these positions will also exert impact on such incentive, which may dilute the effectiveness of the contractor's priority right. The problems to be discussed below will presumably chill contractors' avidity of invoking Article 286.

1. Pre-conditions on the Contractor's Priority Right

Article 286 and the Supreme Court Interpretation set up two major pre-conditions on the contractor's priority right: completion of the construction work and demand for payment. Contractors cannot enforce such right until these conditions are met. However, neither of the two, as provided by the law, is clear enough to warrant a smooth enforcement by the contractor. The vagueness of law might bring about substantial difficulties in practice.

The first condition, completion of work, is not explicitly stated in Article 286. The Supreme Court Interpretation has no straight indication of it as such a condition either. The latter, nonetheless, does say that "the statute of limitations of the priority right is 6 months, running from the date of the *completion* of the construction work". Literally, completion is but one starting point⁵⁸ of the statute of limitations, which essentially stipulates the latest point of time to enforce the right but does not necessarily set restriction on the earliest point of time to do so. Yet it is

⁵⁸ Another starting point is "the completion date as stipulated in the construction project contract".

apparently understood, both by scholars⁵⁹ and practitioners,⁶⁰ that, as a general rule, completion is a prerequisite for enforcement of the contractor's priority right.

It seems quite natural that the contractor must complete his work before asking for the construction price, therefore the priority right, as a security of this price, should be enforceable no earlier than that time. But here "completion" is a word filled with ambiguity. At least two different meanings have been attached to this word in practice. One is "completion and transfer", and the other "completion and inspection".⁶¹ The former is a process "for parties of the construction project contract, viz. the owner and the contractor, to mutually approve the performance of the contract" and the possession of the project will be transferred from the contractor to the owner accordingly. The latter, on the other hand, refers to the administrative approval procedure based on the "completion and transfer" process, and its purpose is to examine whether the construction project complies with various administrative regulations.⁶² In fact, the former may be viewed as a private approval of completion while the latter an official approval. In either case, it seems completion cannot be declared unilaterally by the contractor. These two kinds of approval can be obtained simultaneously or separately.⁶³ When they are not obtained at the same time, the problem will arise as to which should be regarded as a condition on

⁵⁹ See, e.g., Liang, *supra* note 6, at 377.

⁶⁰ See, e.g., Andong Ye, *Shui Lai Xing Shi You Xian Shou Chang Quan* [Who Should Enforce the Contractor's Priority Right?] 8 *Zhong Guo Lü Shi* [China Lawyer] 56, 56 (2004) (The author is a judge of Guangzhou Huangpu District People's Court); Gu, *supra* note 40, at 7 (The author is the vice-director of the Law and Regulation Office of Shanghai Municipal Government).

⁶¹ Gu, *supra* note 40, at 6; Ye, *supra* note 60, at 56.

⁶² Gu, *supra* note 40, at 6.

⁶³ *Id.* at 6.

enforcement of the contractor's priority right. Courts are said to split on this matter⁶⁴ and some commentators suggest that the completion requirement for enforcing the contractor's priority right refers to "completion and transfer", not "completion and inspection".⁶⁵

So long as "completion and transfer" is required before contractors can enforce their priority right, they cannot claim this right without first abandoning possession of the construction project. However, it is said to be a common practice that contractors hold possession (usually by holding keys) to impel owners to pay the construction price as agreed.⁶⁶ Thus, giving up the possession will restrict contractors' capability of self-defense against owners for potential defaults. Of course, to the extent that the priority right could effectively help contractors collect construction prices, possession of the construction projects would not be essential any longer. Yet the real functioning of the priority right deserves some further inquiry. Moreover, as stated above, the exact amount of the construction price remains unknown until the final accounting made after "completion and inspection".⁶⁷ In other words, even if contractors are allowed to enforce the priority right after "completion and transfer", the amount of the credit secured by this right is still unclear. Therefore, it might be practically senseless to interpret the completion requirement as "completion and transfer".

On the other hand, "completion and inspection" may also meet difficulty if taken as a condition to enforce the priority right. As it is usually the owner who should organize the

⁶⁴ Ye, *supra* note 60, at 56.

⁶⁵ Gu, *supra* note 40, at 7, but the reason is not specified.

⁶⁶ Interview with Chen, *supra* note 51.

⁶⁷ Interview with Chen, *supra* note 51; *see also* Ye, *supra* note 60, at 56.

inspection, the contractor will be left in a weak stance if the owner unduly defers this process.⁶⁸ Arguably, under such circumstances, the contractor may exercise his priority right when “the completion date as stipulated in the construction project contract” arrives and unilaterally claim the construction price without final accounting.⁶⁹

If we look at the actual process in construction project contracts, however, neither of the two meanings attached to “completion” is necessarily connected with due dates of the construction price. In short, in a real construction scenario, the payments of such price are made as follows:

Estimate the total price and write it down in the contract ⇒

Pay a certain percentage⁷⁰ of the estimated price as an advance payment ⇒

Pay part of the remaining price periodically during the construction process ⇒

Completion and transfer ⇒ inspection ⇒ final accounting and settling the total price ⇒

Compute the outstanding price = total price - the amount paid ⇒

Pay part of the outstanding price and keep the rest as warranty fee ⇒

Pay the warranty fee if no material defects arise after a certain period.⁷¹ ⁷²

Actually, default on payment may occur in any step of the process, either before or after completion. Given that completion is a pre-condition, when the owner fails to pay the price, as agreed in the contract, before completion, the contractor must complete the construction work with his own money in order to meet the “completion” requirement. On the other hand, if the

⁶⁸ Ye, *supra* note 60, at 56.

⁶⁹ *Id.*, at 56.

⁷⁰ In Shanghai, for example, it’s usually 30%.

⁷¹ In Shanghai, this period is usually 1 or 2 years.

⁷² This process is summarized based on the interview with Chen, *supra* note 51; Gu, *supra* note 40, at 6; and Ye, *supra* note 60, at 56.

owner defaults in paying the warranty fee when it is due, very likely the priority right can no longer be enforced because the statute of limitations has already run. Since the contractor's priority right is security to the construction price it should be enforceable when each part of this price becomes due regardless of completion.⁷³ So the completion requirement appears incompatible with the construction practice.

When the owner defaults on construction price before completion and the contractor cannot continue the construction work at his own expense, the contractor, according to the Supreme Court Interpretation, has to *wait until* the completion date prescribed in the contract, if he wants to rely on the priority right for collection of the price. However, without invoking Article 286, the contractor can *immediately* sue the owner for damages, either under PRC Contract Law Article 107, as an actual default on payment for a given term, or arguably under Article 108 of the same law, as an anticipatory default on payment of the whole construction price. In other words, though there is actionable breach of contract, the contractor still has to wait for the ripening of the priority right, a piece of instrument securing his contractual rights.⁷⁴ Again, the rationale for this wait-until-completion-date rule remains unknown. But one thing is known: this rule makes the priority right less favorable to contractors, as they are now forced to defer from collecting the construction prices.

Finally, the demand requirement raises the question as to what is "a *reasonable* period of time" the contractor must wait before the priority right can be enforced. Given the 6-month

⁷³ Ye, *supra* note 60, at 56.

⁷⁴ Remember that the court, in practice, will not enforce the contractor's priority right unless it is claimed in his suit to collect the construction price.

statute of limitations provided by the Supreme Court Interpretation, such period should be no more than 6 months. Some practitioners suggest that, as a usage of the construction industry, this period should be 8 weeks or 56 days.⁷⁵ Usually, reasonableness depends on specific situations and may only be determined case by case. However, this may well become another ground for owners to challenge the enforceability of the contractor's priority right, which can further defer its enforcement.

2. *Scope of the Priority Right: Is the Contractor Fully Protected?*

Article 286 does not delineate the scope of the construction price secured by the contractor's priority right, while the Supreme Court Interpretation limited the scope to "remunerations of employees, materials fees and such other expenses that the contractor *actually paid* for construction work" (emphasis added).

From a practical perspective, this scope roughly covers the "cost" of the construction work, consisting of, in construction industry's terminology, direct fees and indirect fees.⁷⁶ Obviously, profit is not protected by the priority right. Like other business enterprises, construction contractor aims at making profits. Hence, at first glance, it seems really weird to leave these profits beyond the protection of priority right, if the law is targeted at safeguarding the contractor's interest. But, as mentioned above, given that the court believes the major task of the priority right is laborer-protection, the exclusion of profit becomes quite understandable. Indeed, the focus of the court, regardless of the legislative objective, is on ensuring proper payment of

⁷⁵ Zhu, *supra* note 10, at 47.

⁷⁶ "Direct fee" refers to the expenses arising directly from the construction work, e.g. material cost, labor cost and the cost of preparatory work. "Indirect fee" refers mainly to the monitoring cost of the construction work and is usually calculated as a certain percentage of the direct fee.

wages to laborers. The contractor is bestowed with the priority right merely because, at least in principle, he is the employer of laborers who directly pays these wages. And the coverage of actual costs, such as material costs, can be explained that otherwise the contractor will apply the money obtained through enforcing the priority right to offset these costs. Therefore, insufficient protection to the contractor is a good reflection of the judicial purpose of laborer-protection.

However, it is doubtful, under such a scheme, whether the contractor would have enough incentive to claim the priority right. Especially when the construction cost is largely financed by other participants – laborers and material providers, for example, the contractor could hardly be expected to enforce this right at his own expense merely to satisfy these credits. If material costs (or other actual construction expenses) are paid out of the contractor’s pocket, then, in order to recover these fees, he may be spurred to claim the priority right. In this situation, the labor cost, which is usually credited by laborers, can also be reimbursed with the proceeds of sale of the construction project. In general, the more expenses, other than labor cost, the contractor has advanced with his own money, the better incentive he will have to enforce the priority right, thus, also higher chance for laborers to get their wages. In this sense, laborers can be fairly regarded as free-riders of the contractor’s enforcement. Once the contractor advances a substantial amount of money (larger than the expected enforcement cost) for construction costs, he will be willing to enforce the priority right even if the profit cannot get paid with the proceeds of sale. But this can be said only after the contractor did put his money into the construction project, thus getting his own stake involved. If we examine the contractor’s incentive *ex ante*, however, things may be different. Now that profits do not fall in the sweep of the priority right, this right adds nothing to

the contractor's incentive to advance construction costs in the first place. No rational contractor, as a business entity, will be more willing to make such advances just because he might get secured to take back the same amount of money in the future (probably even without interest) while reaping no profit at all. Moreover, considering the free-rider problem in enforcing the priority right, a rational contractor tend to seek credits from others, e.g. material providers, to finance the construction costs, if he can't be prepaid by the owner. If the contractor does not advance the construction costs with his own funds, as mentioned above, he will not be sufficiently incentivized to enforce the priority right, which means laborers will not have a free-ride either. Actually, under the current legal structural, since laborer-protection can only be realized indirectly through contractor-protection, any distortion in the contractor's incentive will curtail the efforts to protect laborers as well.

3. *Exemption from the Priority Right: A Barrier That Matters*

According to Article 286, if a construction project, in light of its nature, "is not suited to being converted into its monetary value or auctioned off", then it is exempted from the contractor's priority right. What kind of projects bears such a nature? As listed by most commentators, this category may include state-sponsored major projects – such as highways, bridges, governmental buildings – and the projects with special purposes – such as school or hospital buildings.⁷⁷ In practice, virtually no governmental development project will be subject

⁷⁷ See Hu, *supra* note 19, at 439; Jiang, *supra* note 4, at 224; Research Office, *supra* note 19, at 422; see also DSPC, *supra* note 35, art. 23.

to the contractor's priority right. On one hand, there might be legal restrictions in transferability of state-owned projects, while on the other, these projects, usually as facilities for public service, appear to be less attractive to private investors. Imagine, in China, who will bid for the National Opera Hall or the highway connecting Beijing and Shanghai when the usage fee structure is heavily restricted by the state? As for schools and hospitals, those who purchase their physical architecture may also be obliged to provide relevant services accordingly.

From contractors' perspective, these exempted projects will amount to substantial barriers because a great portion of outstanding construction prices arise from these projects. According to official statistics, as of 2004, the total construction price that is outstanding for completed construction projects amounts to \$21.4 billion, among which the governmental indebtedness is above \$7.8 billion or 36.6%.⁷⁸ A numerical comparison will shed more light. The number of indebtedness arising from urban real estate development projects is \$5.7 billion or 26.6%.⁷⁹ So with respect to completed construction projects, governmental default is 10% more than the default by developers in urban real estate market (available statistics do not show who owes the remaining 36.8% construction prices). In terms of transferability, however, there is little doubt that urban real estate development projects, consisting mainly of residential and commercial properties, are best fit for the contractor's priority right. In other words, of the whole construction price default problem, Article 289 can merely solve 26.6% the best, while at least 36.6% can barely be addressed by this article. Some other resources hinted that the state-owned

⁷⁸ See *supra* note 2.

⁷⁹ Zeng Pei Yan Fu Zong Li Zai Quan Guo Qing Li Tuo Qian Gong Cheng Kuan Dian Shi Hui Yi Shang De Jiang Hua [The Address by Vice Premier Zeng Pei Yan at the National Video Conference on Collection of Indebted Construction Prices] (Aug. 23rd, 2004).

construction prices may be even more. For instance, one material said that the 49.5% of the total defaulted construction price arose from the so-called “basic infrastructure construction projects”.⁸⁰ In China, this category can squarely fall in the scope of state-sponsored major projects.

In fact, not only the legally exempted projects but any construction projects that can't be easily transferred in market are beyond the reach of the contractor's priority right. Suppose a factory built a new building on its premises and the construction price was in default. Even if this factory building is not exempted under Article 286, it's still hard to imagine that outside investors would be interested in bidding for such a building as completely encircled by the factory. Apparently, the contractor's priority right is best geared with urban real estate development projects but relatively incapable of dealing with legally or practically non-transferable projects. However, it seems that the former is also less likely to yield construction fee defaults, especially when the urban real estate market is in a boom. In such a market, the owner (also the developer) has less incentive to default for fear of losing the profitable projects. Further, with a smooth cash-flow from purchasers, owners hold enough capability to pay construction prices, too.⁸¹ If that is true, then the contractor's priority right turns out to be, at most, a medicine that cures the least likely disease while leaving those more widespread ones untouched.

4. *Subordination to Consumer's Right: A Potential Trap*

⁸⁰ Zhou & He, *supra* note 31, at 55.

⁸¹ This prediction seems supported by my interview with Chen, *supra* note 51, in which Mr. Chen told me that among the construction projects his company engaged in, urban real estate development projects rarely yield construction price defaults in recent years. But there also exists contrary evidences. It is said that as for Shanghai Jian Gong Group, one of the biggest construction enterprise in Shanghai, 52.3% outstanding construction prices are attributable to urban real estate development projects (Gu, *supra* note 34, at 7). Yet it might worth inquiring the occurring time of such indebtedness and further exploring the market situation at relevant periods.

The Supreme Court Interpretation subordinates contractor's priority right to consumer's ownership of the residential property, if the consumer has paid majority of the purchase price. In practice, most purchasers of residential properties (mainly condominiums) get purchasing loans (normally up to 80% of the total price) *from banks* and pay the whole price *to the owner* in a lump sum (properties so purchased are mortgaged to banks). Thus, paying the majority of the purchase price won't be a big problem for purchasers. On the other hand, "consumer" is a tricky word in this context. Literally, it is supposed to mean the purchasers who buy residential properties for living. If the real estate is bought for purposes other than living, say, for lease or resale, then the purchaser is no longer a "consumer", but an investor or speculator. In reality, however, such purpose-oriented classification doesn't seem to work, probably due to the difficulty in determining purchasers' exact purposes. Therefore, in effect, it appears that virtually any purchaser of residential real estate will be regarded as a consumer. Since these two requirements, paying majority of the price and purchasing as a consumer, will almost always be met without trouble, there is a high probability that the contractor's priority right will be subordinated with respect to residential construction projects.

A prevalent justification for such subordination is the consumer-protection policy. As Professor Huixing Liang stated, in such case, the contractor's business interest should be subordinate to the consumer's living interest.⁸² Yet this kind of subordination constitutes a

⁸² Liang, *supra* note 6, at 379. Obviously, here Professor Liang is deeply influenced by the Japanese "balancing of interest" theory, which ranks interests of various parties and provides legal protection accordingly. From these comments, he appears to take a contractor-protection position as the objective of Article 286, but in the same paper Professor Liang also admits that the rationale for Article 286, at least in part, exists at protecting the laborer's compensations. Anyway, if the contractor's priority right is regarded mainly as a laborer-protection mechanism, it also involves living interest (of laborers) in addition to business

potential trap to the contractor. In short, the owner may collude with purchasers to escape payment of the construction price. One case in this point is as follows. B, the owner, defaulted on construction price and the contractor, A, threatened to bring a suit. B immediately sold all of the 46 residential units in the construction project to C, a related company, and required C to pay the purchase price to bank D, where B got the construction loan. D then offset its loan with the purchase price. At the same time, C quickly resold the residential units to individual purchasers and conveyed titles. After A won his suit against B and attempted to enforce the contractor's priority right, he ultimately found that nothing can be auctioned off at all.⁸³ Actually, even without collusion, the contractor's interest may still be at risk. As mentioned above, partly as a circumvention practice, banks that advanced construction loans to owners would require them to maintain an account in the same bank and use this account to collect the proceeds of sale of the residential projects. Then banks would offset the construction loans with the proceeds in this account.⁸⁴ In current Chinese real estate market, a substantial part of residential properties are sold out before completion of construction, when the contractor is not yet entitled to enforce his priority right. Therefore, even if the contractor intends to claim this right after completion, his efforts could fall through because he might be left with neither the property nor the proceeds.

5. *Other Problems*

Apart from the abovementioned issues, the contractor will encounter still other problems

interest.

⁸³ Lanchun Zhu, *Fa Ding You Xian Shou Chang Quan De Luo Kong* [*The Falling Through of the Contractor's Priority Right*] (2002), at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=art&Gid=335545082>.

⁸⁴ Gu, *supra* note 33, at 28; telephone interview with Kuang Duan, Professor of Law and specialist in secured transaction law, Fudan University School of Law (Dec. 12th, 2004).

that may frustrate his efforts to seek protection under Article 286. One problem exists in the enforcement procedure of the priority right and it can be a time-consuming process. As I have pointed out in section II-1-B, courts require the contractor to go through all trial proceedings and obtain an ultimate judgment before applying for execution of the priority right. With all the defenses that can be used by both the owner and his creditor, the bank, the trial itself might be a long race. Even when this process goes on smoothly and the execution application is promptly approved, the auction process will cost the contractor another months of time. In practice, before the auction can be made, the value of the construction project must be assessed and auction advertisement published in major local newspapers. If bidders do appear and the project is really sold at the auction, it will take at least 2 months to go through the whole process: evaluation → advertising → auction.⁸⁵ However, it is said that, very often, bidders do not actively attend and bid at auctions.⁸⁶ In that case, the auction may be suspended for 1 or 2 years before a new round can be called, and under certain circumstances, the execution judges even have to seek bidders personally. When the project to be auctioned off is incomplete (the circumstance under which the contractor is entitled to enforce his right when the completion date stipulated in the contract comes), it is particularly troublesome to find purchasers and may take as long as several years to get the auction, if ever, settled.⁸⁷

Such a time-consuming process is common to all real estate execution cases, no matter

⁸⁵ Telephone interview with Xiumin Qin, Judge, Tianjin Dagang District People's Court (Nov. 16th, 2004).

⁸⁶ Tiehua Liu, *Guan Yu Cheng Bao Ren Gong Cheng Kuan You Xian Quan De Cao Zuo Nan Dian* [The Practical Difficulties in the Contractor's Priority Right] 3 Jian Zhu Jing Ji [Construction Economy] 30, 31 (2000).

⁸⁷ Interview with Qin, *supra* note 85.

based on the priority right or not. As for contractors, or more specifically their laborers, nevertheless, it will turn out to be a critical problem. Under the current compensation system, construction laborers are usually paid with a small amount of stipends during the year, and the major part of their annual wages will be paid at the end of the lunar year.⁸⁸ Construction laborers, mainly coming from the countryside, will bring their annual incomes back to hometowns during the spring festival holidays. If laborers cannot get wages due to the owner's default, they won't be able or willing to go back home at the spring festival, which, under traditional Chinese culture, can be a really big issue to the laborer, his or her family, as well as the society. Therefore, although a time-consuming process of collecting debts is generally undesirable to creditors, the timing of getting paid may be exceedingly sensitive to construction laborers.

The last concern I want to mention is contractors' fear of worsening their relationship with owners. In current Chinese construction market, contractors are believed to be at an inferior position to the owner. The fundamental reason for this inferiority exists in the fact that too many contractors are competing for relatively few construction projects.⁸⁹ Thus, the market mechanism tips the scale in owners' favor. If the contractor dares to claim the priority right, it may well mean that he has broken the relationship with the owner and could not get business from the same owner in future. Under the so-called "rolling development" scheme, quite popular at present, one owner will develop a huge project that is further divided into several subprojects. These subprojects will be developed one after another. Sometimes, the owner won't pay the

⁸⁸ Interview with Chen, *supra* note 51.

⁸⁹ Jianjun Dong, *He Tong Fa Di 286 Tiao Ruo Gan Fa Lii Wen Ti Tan Tao* [Discussions About Several Legal Problems in PRC Contract Law Article 286] 12 *Jin Rong Lun Tan* [Financial Forum] 24, 26 (2002); *see also* Gu, *supra* note 34, at 9.

construction price of the first subproject until the completion of the second one.⁹⁰ If the contractor breaks his relationship with the owner at an earlier phase, he might lose potential profits in all subsequent phases. Even if the contractor does not expect to continue the relationship with a certain owner, his fame of aggressively enforcing the priority right might spread in the industry, thus affecting the contractor's future business opportunities. Exactly for these reasons, contractors are fairly ready to agree to waive their priority rights.⁹¹ Some commentators sympathetically call for contractors to take stronger position against owners,⁹² nevertheless, this sympathy seems short of a sound business sense.

D. Is the Contractor More Secure: Summary of the Functional Analysis

In the previous sections, I have attempted to review the actual positions of some key players under the Article 286 scheme. In principle, this scheme is designed to strengthen the contractor's status against the owner and stimulate the latter to appropriately pay the construction price. In essence, however, it readjusts the interests between the contractor and other creditors of the owner, mainly, the bank and the purchaser. As a result of this legal design, the priority among these parties now becomes: the purchase (if as a consumer) in the first and the bank in the last. With respect to the owner, his position remains practically unchanged. That is because no matter the contractor's priority right exists or not, the construction project, as the most easily identifiable asset of the owner, is almost always subject to repossession and sale in case of default on

⁹⁰ Interview with Duan, *supra* note 85.

⁹¹ See references in *supra* note 34.

⁹² Gu, *supra* note 34, at 9.

construction prices. The difference merely exists at the order of distributing the auction price among his creditors. Partly for this reason, I dispensed with exploring the owner's reactions to the contractor's priority right.⁹³

Then, is the contractor more secure because of the priority right? With promotion of status against the bank, the contractor is supposed to be more secure in that more proceeds will be distributed to him if the construction project is sold. But this result only arises where the contractor's priority right can be and is really enforced. This will further depend on courts' interpretation, banks' strategy and contractors' incentive. Under the current system, I would conclude tentatively that the priority right is not totally favorable to the contractor. It seems that courts are not ready to extend full protection to the contractor and banks will prefer circumventing measures to fend off the priority right. Above all, the market mechanism also works against the contractor. Even if the contractor's priority right can be rightly applied, it is still noteworthy that it can tackle no more than the construction projects legally and practically transferable. Perhaps due to all these qualifications, an insider of the construction industry cautiously reminded his colleagues that before resorting to the contractor's priority right for collecting construction prices, "the feasibility must be well studied and absolutely should not (enforce this right) at will".⁹⁴ To do or not to do – it is really a problem.

Finally, as for courts' (maybe also legislators') objective of protecting laborers, it should be mentioned that, by all means, this is at most a side-effect of the contractor's priority right. To

⁹³ Another reason is lack of relevant materials.

⁹⁴ Liu, *supra* note 87, at 31. The author is an officer of Shanghai Jian Gong Group, Inc., a giant construction enterprise in Shanghai.

what extent it can be realized largely relies on how well the contractor is actually protected under Article 286. Even if the contractor is more secure, the laborers are not necessarily better protected, either, as the money goes directly to the contractor's pocket and he may apply it for purposes other than paying laborers' wages.

III. SOME REFLECTIONS ON THE CONTRACTOR'S PRIORITY RIGHT UNDER THE PRC CONTRACT LAW

A. Policy Arguments for the Contractor's Priority Right

"First in time, first in right", that is the basic rule about the priority of security interests under Chinese law. Then, why should the contractor enjoy a statutory lien that prevails over even mortgages perfected earlier? There are two major policy arguments frequently mentioned by Chinese commentators.

First, it is said that a substantial part of the construction price is composed of laborers' wages. So the priority right is chiefly aimed at laborer-protection, which stands for a significant public policy. This argument wins strong support from courts and is also endorsed by some major scholars.⁹⁵ Yet laborer-protection is a general issue that exists in every industry. It can be said that labor cost, or laborer's wages, is included in each and every kind of price. Every item sold in the supermarket, for example, entails such cost. And if its price is not properly paid, the chance may increase, more or less, that laborers producing this item will not get fully paid of their wages. Indeed, default on laborers' wages is by no means a unique phenomenon merely existing

⁹⁵ Liang, *supra* note 6, at 378.

in the construction industry. So it seems strange that the law provides special protection solely to construction laborers. A possible rationale on this track is that construction laborers are the most vulnerable to such attack, or else, most likely to be attacked. But this cannot be easily established without relevant empirical evidences. After all, the contractor's priority right is but an indirect mechanism for laborer-protection.

The second argument is advocated by practitioners in construction industry. This essentially is a contractor-protection argument emphasizing that the construction project is built largely on the contractor's credit. The contractor provides both materials and labor, so "the buildings to be auctioned off (under Article 286) essentially belong to the contractor".⁹⁶ Consequently, some commentators argue that there is "an inherent connection between the construction price and the construction project" which cannot be found as for other credits.⁹⁷ Only empirical studies can verify whether the construction project is largely credited by the contractor. This argument seems suspectable, however, given the fact that banks do advance *substantial* construction loans to most, if not all, projects. In some places, it is said that the construction loan could be as much as 70% of the whole cost involved in development.⁹⁸ Even though the construction cost is actually financed by the contractor, this cost but stands for part of the value of the construction project. Before the contractor can begin construction, lots of

⁹⁶ Gu, *supra* note 34, at 8, citing Liwen Shi, President of Shanghai Jian Gong Group.

⁹⁷ Wang, *supra* note 17, at 66. Professor Huixing Liang also agrees with this second argument. It seems that he takes it as a supplement to the first, i.e. laborer-protection, argument (*see* Liang, *supra* note 6, at 378).

⁹⁸ Telephone interview with Jian Zhang, lawyer and specialist in construction law, Fujian Jun Li Law Firm, Beijing Office (Mar. 19th, 2005) (This percentage was provided by a bank officer in Fujian province). In Shanghai, the ratio of construction loan is said to be up to 40% in practice (interview with Miao, *supra* note 53).

preparatory work must be done. Most obviously, the owner must obtain the land use right, resettle the residents on that land and make other preliminary preparations. Costs for this kind of work are indispensable to the construction project. If these expenses are not paid by the contractor, the question will arise whether the project really belongs to the contractor. In theory, it can be argued that the contractor's priority right exists merely on the value of the project – i.e. the building, but not on the land.⁹⁹ However, I am skeptical whether, in practice, the preparatory costs, such as mentioned above, can be attributed solely to the value of either the building or the land. Furthermore, when the construction loan is really used to pay some of the construction cost, the argument becomes even less convincing that one provider of such cost (the contractor) should be prior to another (the bank).

Apart from the above two arguments, there is still a third, yet less common, rationale for the contractor's priority right. It says that the value of the construction project is attributable to the contractor's work and that "the existence of this value constitutes the *basis* for the realization" of "other credits (secured by the construction project)" (emphasis added).¹⁰⁰ But for the contractor's work, other creditors would have nothing to sell for satisfaction of their secured credits. As stated above, nonetheless, labor, material and capital all contribute to producing the value of construction projects. When these elements are not provided wholly by the contractor,

⁹⁹ It has not been settled by the court whether the priority right covers the value of the land. Some commentators suggest that the land value should be excluded from the range of this right (*see* Zongguo Yao & Pu Cui, *Jian She Gong Cheng Jia Kuan You Xian Shou Chang Quan Fa Lü Wen Ti Tan Xi* [*Plobing the Questions in the Contractor's Priority Right*] 8 *Zhong Guo Lü Shi* [Chinese Lawyer] 60, 60 (2004)).

¹⁰⁰ Wang, *supra* note 17, at 66; see also Nuo Ji & Wei Zhang, *Qian Shi Jian She Gong Cheng He Tong Zhong De Fa Ding You Xian Quan* [*A Preliminary Explanation to the Contractor's Priority Right*], at <http://www.netlawcn.com/second/article.asp?artno=542>. It used to be my own position on this issue.

this third argument is still unpersuasive in term of the reason for contractors being placed at an advantageous position over other providers, who collaboratively set up the so-called *basis*.

B. Cost-Benefit Analysis: Risk Alteration v. Monitoring Efficiency

By and large, the above policy arguments focus on the *fairness* among various creditors of the owner. Nevertheless, each of them leaves questions yet to be answered. Here below, I try to explore the issue from the aspect of *efficiency* by doing a cost-benefit analysis of the contractor's priority right. In particular, I will stress two effects arising from the change of priority rank between the bank and the contractor, namely, risk alteration and monitoring efficiency.

1. Risk Alteration

The general rule about the priority rank among secured creditors – first in time, first in right – is considered to be a response to the problem of risk alteration.¹⁰¹ In other words, according to this theory, risk alteration might occur or aggravate where the general rule is not followed. Since the contractor's priority right creates an exception to the general rule, risk alteration is a conceivable cost of Article 286.

Risk alteration is a phenomenon closely associated with limited liability. Under the limited liability system, no matter how serious the loss might be, an investor's liability is restricted to his equity assets, and any loss beyond that will be borne by his creditors. If the investment succeeds, however, any profit, less the fixed interests of loans, will belong to the investor.

¹⁰¹ Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 Va. L. Rev. 2103, 2108 (1994).

Therefore, when the investor has few assets himself and is mainly playing with other persons' money, he will concentrate merely on the upside potential of the investment. Other things being equal, the more debt one uses to finance his investment, the less he will care about the risk in such investment. To the extreme, when the investor does not have any asset of his own, he won't consider about the risk at all, as he need not bear loss in any event. A great enough upside potential gives the investor an incentive to engage in even socially inefficient investment.

Usually creditors charge interests for their loans to offset risks. A creditor, however, can only assess the risk, and set the interest rate accordingly, based on the situations known to him at the time of reaching the loan agreement, including the amount of equity and debt used to finance the investment. If the investor borrows new money from another creditor thereafter, he will have more incentive to engage in a riskier investment, or invest with a riskier method (yet with greater upside potential), as the percentage of the investment composed of his equity will be diluted by the infusion of the new debt. It is difficult for the original creditor deal with this specific risk resulting from later borrowing by adjusting interest rates *ex ante*, since he does not have good information of such risk when the loan agreement is concluded. Given that the previous creditor cannot, due to transaction costs, be compensated, *ex post*, for increased riskiness arising from every subsequent borrowing, the "first in time first in right" rule "is a more practical means of solving the risk alteration problem".¹⁰²

In our context, risk alteration is likely to be a real issue. When the owner has obtained

¹⁰² *Id.* at 2112-2113 (explaining why the transaction cost may preclude a variable interest rate arrangement that compensates the previous creditor for any increased risk, *ex post*, resulting from each subsequent borrowing).

the construction loan but still requires the contractor to advance construction costs, he would be able to use the loan for other purposes, probably a riskier investment. To be more specific, in the urban real estate development circle, some owners use construction loans to acquire the land use rights of other tracts for future development (so-called “rolling development”).¹⁰³ If such new investment increases the overall riskiness of the development plan, actually the risk of the construction loan is altered. Now the bank is subject to a higher risk than it contracted for. But for the advances made by the contractor, the owner would not have opportunity to engage in a potentially riskier investment.

A numerical illustration (hereafter, Illustration1) may be helpful to understanding. Suppose that Investment A entails \$300 cost, in which \$100 is financed by the investor’s equity and \$200 by Creditor1 (hereafter, C1) at an annual interest rate of 10%. Further suppose that Investment A has a 50% chance of turning into \$1,000 by the end of the year and another 50% chance of shrinking to \$250. In this case, the social payoff is $\$1,000 * 50\% + 250 * 50\% - \$300 = \$325$; the investor’s payoff is $(\$1,000 - \$200 * 110\%) * 50\% + (\$250 - \$200 * 110\%) * 50\% - \$100 = \305 ; C1’s payoff is $\$200 * 110\% - \$200 = \$20$. Now assume that Creditor2 (hereafter, C2) advances another \$200 loan at an annual interest rate of 15%, which makes the investor to engage in Investment B (Investment A can be a subproject included in Investment B) involving \$500 cost. Also assume that Investment B has a 50% chance of yielding \$1,300 by the end of

¹⁰³ In my interview with Mr. Chen, he told me one case in which his company was not able to collect the construction price of an urban real estate development project. The reason leading to the owner’s default was that the construction loan, maybe with his own equity, was invested to get the land use right of a new tract. Mr. Chen also said that, in his memory, it was the only case in which an owner of an urban real estate development project defaulted, to his company, in construction price (interview with Chen, *supra* note 51).

the year and another 50% chance of shrinking to \$210. All other conditions remain unchanged. In this new investment, the social payoff changes to $\$1,300 * 50\% + \$210 * 50\% - \$500 = \255 ; the investor's payoff now becomes $(\$1,300 - \$200 * 110\% - \$200 * 115\%) * 50\% + \$0 * 50\% - \$100 = \325 . In Investment B, as we have seen, the investor's payoff increases by \$20, which gives him an incentive to engage in this investment. However, the social payoff in Investment B decreases by \$70, which means, from the social prospective, the investor should engage in Investment A rather than B. C2's new money actually leads to a less socially efficient investment. If no priority right exists and the "first in time, first in right" rule applies, C1's payoff in Investment B is $\$200 * 110\% * 50\% + \$210 * 50\% - \$200 = \15 ; and C2's payoff is $\$200 * 115\% * 50\% + \$0 * 50\% - \$200 = -\85 . Obviously, even without the priority right, C1's payoff decreases by \$5, due to the risk alteration problem. Now let's see the potential function of the priority right. If the subsequent creditor C2 can prevail over the previous creditor C1, then, in Investment B, C1's payoff becomes $\$200 * 110\% * 50\% + \$0 * 50\% - \$200 = -\90 , while C2's payoff turns to $\$200 * 115\% * 50\% + \$210 * 50\% - \$200 = \20 . If C2 knows his payoffs both with and without the priority right, he will rationally be ready to advance new money in the former case, but refrain from doing so in the latter. This result shows that the priority right encourages subsequent creditors to provide new loans. Such loans may bring about increased riskiness to the previous creditor's loan and lead to less socially efficient investment as well. The above results of Illustration 1 are summarized in the table below.

	Social Payoff	Investor's Payoff	C1's Payoff		C2's Payoff	
Investment A	\$325	\$305	\$20		N/A	
Investment B	\$255	\$325	With Priority Right	Without Priority Right	With Priority Right	Without Priority Right
			-\$90	\$15	\$20	-\$85

Now let's change a few factors in Illustration1 (This new illustration is called Illustration2 hereafter). Assume that Investment A is financed with only \$50 equity and \$250 debt from C1, other conditions being equal. The investor's payoff becomes $(\$1,000 - \$250 * 110%) * 50\% + \$0 * 50\% - \$50 = \$312.5$. Suppose further that the upside potential of Investment B changes to \$1,250, and that the investor use \$50 equity and \$450 debt (including \$250 from C1 and \$200 from C2) to finance it. All other conditions remain the same. Then the investor's payoff in Investment B turns to $(\$1,250 - \$250 * 110\% - \$200 * 115%) * 50\% + \$0 * 50\% - \$50 = \322.5 . So in Illustration2, the investor will engage in Investment B if its upside potential is \$1,250, but in Illustration1 he will not if the upside potential of Investment B is that much (because then the investor's payoff in Investment B is \$300, less than in Investment A, \$305). This comparison between Illustration1 and Illustration2 shows that the lower percentage of equity the investor applies to the investment, the more likely he will practice risk alteration when new debt arises. Actually, in Illustration1, the investor will have an incentive to engage in Investment B, the riskier investment, only if its upside potential is greater than \$1,280; but in Illustration2, he will turn to Investment B once the upside potential is greater than \$1,230.

It should be noticed that the above two illustrations merely proves that a subsequent borrowing may stimulate the investor to take part in a riskier investment, but by no means implies that the every new investment in which the investor manages to engage is necessarily a riskier one (i.e., Investment B can be less risky than, or as risky as, Investment A though it entails a higher cost). Therefore, in the context of urban real estate development, if the owner uses the construction loan to acquire another land use right for a new project, he does raise the probability of risk alteration, but not engage in risk alteration for sure. It depends, eventually, on the upside and downside potential of the scheduled new project.

2. *Monitoring Efficiency*

Apart from the risk alteration problem, the divergence from the general rule – “first in time, first in right” – will presumably bring about a second effect: altering creditors’ incentive to monitor the “debtor misbehavior”.

As stated before, the interest rate of a loan agreement is usually fixed and it normally reflects the risk level expected by the creditor when the agreement is reached. Nevertheless, “the debtor has an incentive to increase the riskiness of the loan” after it was made, “since, by doing so, he effectively obtains a higher-risk loan” at a lower interest rate.¹⁰⁴ This phenomenon of opportunism is referred to as “threat of debtor misbehavior”.¹⁰⁵ In fact, the risk alteration problem can also be considered as one form of “debtor misbehavior”.

As for the creditor, one way to reduce the “threat of debtor misbehavior” is “to monitor

¹⁰⁴ Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 Yale L.J. 1143, 1149 (1979).

¹⁰⁵ *Id.*, at 1150.

the debtor's conduct after the loan has been made".¹⁰⁶ In other words, the creditor can keep watch on the debtor's behavior and prevent him from doing anything that may increase the riskiness of the loan. For example, the creditor can preclude the subsequent borrowing that may give rise to risk alteration.

However, the existence of a security interest gives the creditor less incentive to practice monitoring, because "so long as the particular items of property securing his loan remain intact, a creditor will be immunized from the effects of his debtor's misbehavior",¹⁰⁷ thus less monitoring is needed to prevent the increase in riskiness of a secured credit. By the same token, subordination of the priority of a creditor's security interest will add to his incentive to monitor the debtor's misbehavior, if part of his secured credit may become unsecured after such subordination. In this sense, the priority right can encourage the previous creditor to practice more intensive monitoring.

The following numerical illustration shows how the creditor's incentive to monitor changes with the subordination of his security interest. Suppose that Creditor3 (hereafter, C3) lends \$10,000 to the debtor and that this credit is secured by the collateral with a market value of \$15,000. Further suppose that it takes C3 \$100 to monitor the debtor's behavior. Under C3's monitoring, the probability of the debtor's default is 10%, but otherwise, it would be 50%, and in case of default, the loan can be repaid only by selling the collateral. If C3 holds the first priority on the collateral, he will have no incentive to monitor at all since his loan will be fully repaid, even

¹⁰⁶ *Id.*, at 1150. In this paper, however, the word "monitor" is used in a broader sense, not only including the monitoring done after the loan is made, but selection of debtors beforehand as well.

¹⁰⁷ *Id.*, at 1153.

without monitoring, by enforcing his security interest in the collateral. In this case, the \$100 monitoring cost is a net loss reaping no benefit. Now assume that Creditor4 (hereafter, C4) gets a priority right on the collateral securing his loan of \$8,000, thus C3's credit subordinate to C4's credit. For convenience, let's assume that the debtor will also default on C3's loan as long as he defaults on C4's credit. In this situation, C3's payoff will be $\$10,000 * (1 - 10\%) + (\$15,000 - \$8,000) * 10\% - \$100 = \$9,600$, if he monitors; and $\$10,000 * (1 - 50\%) + (\$15,000 - \$8,000) * 50\% = \$8,500$, if he does not. Obviously, C3 does have incentive to monitor when the priority rank of his security interest changes from the first to the second. Therefore, the priority right may increase the previous creditor's monitoring incentive to diminish the "threat of debtor misbehavior".

From Illustration1 in the above section, we conclude that without the priority right, subsequent creditors, willing to provide new loans, are less likely to appear, thus lessening the risk alteration problem. However, this conclusion is made on the assumption that subsequent creditors have full knowledge of their potential payoffs both with and without the priority right and can take rational actions accordingly. If, due to information asymmetry, subsequent creditors cannot accurately predict their potential payoffs when no priority right exists, they might make new loans even without this right. Under such circumstance, abolishing the priority right will not help avoid the problem of risk alteration. The previous creditor's monitoring, nonetheless, may prevent risk alteration in this event, by restricting the debtor's engagement in riskier investments. In short, when subsequent creditors provide new money anyway, the mere existence of the priority right will not increase the potential of risk alteration, while the previous creditor's monitoring

lowers this potential.

In current Chinese construction market, it seems quite possible that the contractor will advance construction costs even without the priority right. Indeed, the very purpose of adopting Article 286 is to deal with the huge amount of unrecoverable construction fees. Some commentators believe the fact that contractors advance construction costs even without the priority right can be explained by their vulnerable positions in the market. In brief, the competition among contractors is so fierce that they have to advance construction costs for owners; otherwise business opportunities will go away.¹⁰⁸ However, I would like to explain this phenomenon as a result of the information asymmetry between the owner and the contractor. The contractor is not able to know the effect of his advances on the owner's investment plan, and therefore cannot predict accurately his potential payoff. Otherwise, if the contractor expects that his advances will stimulate risk alteration and leave him with a negative payoff, he will rationally not make such advances or engage in the construction work, because winning this work will essentially make him worse off. No matter how vulnerable the contractor's position might be in the market, he is still free to choose to stay away.¹⁰⁹ Therefore, to the extent that information asymmetry precludes the contractor from making a rational business choice, the risk alteration cannot be considered as worsened by Article 286, and its abolition will not necessarily save the social costs resulting from risk alteration.

In a word, two alternative approaches help avoid the risk alteration problem. One is to

¹⁰⁸ See, e.g., Gu, *supra* note 40, at 8.

¹⁰⁹ Of course, the contractor's vulnerable position may add to his difficulty in obtaining relevant information.

give contractors access to information about owners' investment and keep the "first in time first in right" rule. Under this approach, contractors will not be willing to advance construction costs if their payoffs are expected to be negative, so that owners do not have new money to alter risk. In effect, this first approach leaves the monitoring task with contractors. Another approach is to furnish contractors with priority right. Under this approach, banks will have more incentive to monitor owners' investments, so that owners are restricted in risk altering practices. It should be ultimately decided by empirical evidences which approach is the more efficient. Intuitively, however, the former seems less practical and contractors tend to be less efficient monitors than banks. Generally speaking, contractors, because of their weak positions, do not have enough bargaining power to impel owners to disclose information. Even if the law imposes disclosure responsibilities on owners, for the same reason, contractors have less control over owners' behavior and are not likely to prevent their deviation from the original, less risky investment plan. On the other hand, banks are considered to be at advantageous positions over owners. They may require owners to assume contractual responsibilities to disclose investment plan as well as periodic financial statements, so that banks can more easily assess the financial effects of owners' actions. At the same time, to facilitate loan applications or minimize interest rates, owners will have incentives to prove themselves as good debtors, thus voluntarily provide information to banks.¹¹⁰ In short, banks' monitoring involves relatively lower information cost. Moreover, banks can also restrict owner's ability to borrow new debt from other sources through contractual

¹¹⁰ Good debtor's incentive to disclose information to creditors is explained in Alan Schwartz, *A Theory of Loan Priorities*, 18 *Journal of Legal Studies* 209, 220 (1989).

arrangements, such as the negative pledge clause. Aware of owners' any breach of loan contracts, or any action that may increase riskiness of loans, banks can conveniently penalize such misbehaviors by stopping advances of new loans or calling advanced loans. In addition, holding the accounts for construction funds and proceeds of sales, banks can also easily control owners' cash flow. Thus, the enforcement costs essential to banks' monitoring are also comparatively low. Finally, as for those "threat of debtor misbehavior" that cannot be averted with efficient monitoring, banks can simply increase the interest rate to make up for the risk.¹¹¹ Usually, however, contractors may not be so flexible in setting their profit rate to counteract extra risks.¹¹²

Some literature has noticed this potential function of Article 286 – banks will develop effective monitoring mechanisms for construction funds.¹¹³ Banks' responses to the this rule reveal, in some degree, their willingness to improve monitoring over owners' misbehaviors. For instance, the equity requirement for applying for construction loans was emphasized and its percentage raised from 30% to 35%. As Illustration2 shows, the more equity the owner applies to the construction project, the less incentive he will have to practice risk alteration. So this requirement essentially alleviates banks' burden to monitor. Banks may also request for contractors' written acknowledgement before advancing loans to owners. Such request functions

¹¹¹ See Jackson & Kronman, *supra* note 105, at 1150-1151 (explaining the relationship between monitoring and raising interest rate, as alternative measures to deal with debtor misbehavior).

¹¹² In Shanghai, for instance, the profit rate of construction work is stipulated, by local guideline for budgeting of construction project, to be 7%. But because of market competition, the actual profit rate tends to be even lower (interview with Chen, *supra* note 51). In contrast, commercial banks have more freedom to set interest rates. The People's Bank of China, Chinese central bank, provides a guidance rate periodically and commercial banks can set their own rates within a certain range. According to the latest provision, the lower limit of the range is decreasing the guidance rate by 10% and no upper limit is imposed (interview with Miao, *supra* note 53).

¹¹³ Gu, *supra* note 40, at 4.

as supervision over the usage of construction loans, so that contractors have less chance to increase the riskiness.

Summarizing the cost-benefit analysis made above, we can conclude that, in light of the situations in current Chinese construction market, Article 286 may not substantially increase the risk alteration problem resulting from contractors' advances of construction costs, but it may promote banks' incentive to monitor owners' misbehavior, thus, lowering the probability of risk altering. Therefore, Article 286 gives rise to more social benefit than cost and it can be justified on this efficiency basis.

C. Some Proposals for Amendment

If, as the cost-benefit analysis shows, the contractor's priority right stimulates banks to improve monitoring over owner's conducts, then contractors are supposed to be benefited indirectly. Essentially, we can take banks, owners and contractors¹¹⁴ as a group of investors. Both banks and contractors advance credits to owners and depend on the success of construction projects for profits. In this sense, owners can even be regarded as their agents to make profit because it is owners who directly take charge of the investment in construction projects. The agent's opportunism can cause harm to all principals, yet once any principal monitors the agent's misbehavior, the effect will also spill over to other principals.¹¹⁵ In our context, if banks preclude

¹¹⁴ In case of urban real estate development, where purchasers buy residential units before completion of construction and pay prices in advance, these purchasers may also be included.

¹¹⁵ This does not necessarily mean that other principals are free-riders. If, due to increased costs of monitoring, banks charge higher interest rates of construction loans, owners may share these costs with contractors by bargain for lower construction prices. Therefore, assigning the monitoring task to the most efficient monitor betters off the whole group by minimizing total monitoring costs.

owners from altering risks and assure effective usage of construction funds, the default on construction prices will become less likely.

However, this prediction appears incompatible with my conclusion from the functional analysis that the current design of Article 286 does not help contractors much. To explain this contradiction, it should be noticed that the cost-benefit analysis is based on the assumption that secured creditors, with different priority ranks, of the same debtor play in a *free market* mechanism. Under this assumption, the senior creditor is able to sell the collateral if the debtor defaults, while the junior creditor is at a risk that his credit cannot be fully recovered if the sale really happens. In reality, this assumption may not be valid for various reasons. Not infrequently, governmental development projects are financed by governmental budgets rather than commercial banks, so there are no junior creditors to monitor owners, usually governmental entities, for the benefit of senior creditors, i.e. contractors. Moreover, these projects do not have transferability, at least in the commercial market. They are essentially “security-proof”. As a result, the contractor’s priority right is of no merit with respect to governmental development projects. Instead, some non-market measures, like administrative orders, may be more effective to alleviate defaults on construction prices. On the other hand, as for those situations that do satisfy the above assumption, particularly in case of urban real estate development projects, some amendments to the current scheme of the contractor’s priority right will probably improve its effectiveness.

1. *Precluding Circumvention*

Bank will have incentives to monitor only when no other less costly methods exist to

offset the negative influence imposed by the contractor's priority right. One such method is to circumvent Article 286. As shown in section II-B-2, banks are more willing to try circumvention than practice monitoring. With these circumventing measures, banks' positions remain intact even after the adoption of Article 286, so they do not need to do more monitoring than before. In order to inspire efficient monitoring by banks, therefore, circumventing arrangements must be nullified.

First of all, any waiver made by contractors *ex ante* should be invalid. This is to prevent the simplest and most direct circumvention. It must be noted, however, that contractors may still refrain from enforcing their priority right when default actually occurs. In any event, it is a *right* held by contractors and nobody can obligate them to use it. It is true that banks might have less incentive to monitor when they expect that contractors will not enforce the priority right in the end. But in most cases, banks will presumably act under the shadow of Article 286. They can be more diligent with the uncertainty about whether the strings will be pulled eventually. Consequently, *ex post* waivers erode the effectiveness of Article 286 to a lower extent than *ex ante* waivers.

Second, proceeds of the construction projects should be subject to the contractor's priority right. Article 286 functions when banks lose to contractors so that they would diligently monitor owners. However, if banks can conveniently offset their loans with the proceeds of construction projects, they are actually entitled to a priority, on the proceeds, senior to contractors. Since proceeds represent the value of the collateral, this entitlement squarely compensate for banks' loss intended by Article 286. Therefore, a special account should be kept for proceeds of

the construction project and money in this account pledged for the benefit of the contractor. Only after the construction price is fully paid, will the bank be allowed to offset the construction loan with the money in this special account. Insofar as proceeds are subject to the contractor's priority right, any threat arising from contractors' subordination to purchasers, whether consumers or not, will no longer be an issue. Although contractors cannot chase collaterals after their titles are transferred to purchasers, they are still secured by the value of these collaterals.

The above proposals focus on but two forms of circumvention frequently seen at present. New measures should be taken, without delay, to deal with any other sort of circumvention that may substantially weaken the effectiveness of Article 286 in future.

2. *Registration Requirement*

One amendment frequently proposed by commentators is that contractors must register their priority right in advance; otherwise, they cannot enforce it when owners fall in default.¹¹⁶ The main reason for this requirement is to protect owners' other creditors, including banks.¹¹⁷ In addition, registration is sometimes said to prevent frauds in calculating the construction price.¹¹⁸ Essentially, the most important item to register is the amount of this price.

¹¹⁶ See, e.g., Jun Zhang, *Lun Jian She Gong Cheng You Xian Quan De Cheng Li Yu Deng Ji* [On the Establishment and Recording of the Contractor's Priority Right], 6 *Dang Dai Fa Xue* [Modern Legal Science] 48, 49 (2003); Tongbi Hu, *Wo Guo Tai Wan Di Qu Min Fa Cheng Lan Ren Di Ya Quan Zhi Qiu Gai* [On the Amendments to the Contractor's Mortgage Right Under Taiwan Civil Code] 5 *Xian Dai Fa Xue* [Modern Law Science] 147, 150 (2003); see also Gu, *supra* note 33, at 26; Dong *supra* note 90, at 25-56. All these proposals merely require contractors to record *in advance*, yet none of them made clear whether contractors should record before starting construction work, or else, completion of work, when the priority right is ripe for enforcement. Most commentators refer to Japanese Civil Code and Taiwan Civil Code as sources of this recording requirement. According to Japanese Civil Code (art. 338), the record should be made before starting work, but Taiwan Civil Code (art. 513) allows contractors to record even after completion.

¹¹⁷ Zhang, *supra* note 116, at 49; Hu, *supra* note 116, at 149.

¹¹⁸ Gu, *supra* note 33, at 26.

With the registration requirement, owners' subsequent creditors and transferees of construction projects will be informed of the contractor's priority right, so that they could internalize potential risks into their interest rates or purchase prices. Registration does make subsequent parties much safer in transactions. It isn't beyond doubt, however, whether such requirement will do substantial good to owners' previous creditors, in particular, banks lending construction loans. Banks normally make loans and perfect mortgages before contractors can file registration of their priority right. Registration is not necessary for banks to know the fact that contractors have priority right, since the law has made this crystal clear. But if banks want to keep aware of the amount of the senior credit, the construction price, they will have to check the registry from time to time.¹¹⁹ Even if banks know this amount, it does not tell the likelihood of owners' default on the construction price. So banks cannot rely on such registration to decide the essential level of monitoring. In other words, this kind of registration does not reduce banks' information costs for monitoring. A practical problem in the registration requirement is that the amount of the construction price secured by the contractor's priority right will be fixed once it is registered. However, as pointed out earlier, the actual construction price will change during the whole construction process and the amount written in the contract is no more than an estimate. If the registration based this estimate precludes contractors from claiming actual construction prices exceeding that amount, the value of the contractor's priority right might be discounted.¹²⁰

¹¹⁹ This is not because the amount recorded tends to change but rather because contractors may be entitled to record at any point within a certain period of time.

¹²⁰ In fact, this is a main reason why the contractor's priority right is of little practical use in Japan (see Wei Zhang, *Ri Ben Dan Bao Wu Quan Fa Xiu Gai Zhi Chu Bu Yan Jiu* [A Preliminary Study on the Amendments to Japanese Secured Transaction Law] Vol.5 No.2 Bei Da Fa Lü Ping Lun [Beijing University Law Review] 471, 474 (2004)).

To facilitate banks' monitoring, contractors should be encouraged to disclose information relevant to the riskiness of construction loans. Therefore, in my point of view, while registration may be required for the safety of subsequent parties in transaction, contractors should also be required to notify banks, without delay, of any default on payment of construction prices.¹²¹ Otherwise, contractors are not allowed to enforce the priority right to collect the construction prices defaulted by owners. To illustrate, assume that according to the construction project contract, the owner should have paid \$10,000 to the contractor on September 1st and another \$10,000 on October 15th, but the owner defaulted on both payments. If the contractor did not notify the bank of the first default before, say, September 10th and merely notified of the second default on October 16th, then he could not enforce his priority right later to collect the first \$10,000, and was only allowed to collect the second \$10,000. This kind of information about owners' default will help banks judge the riskiness of their loans and conduct the necessary monitoring accordingly.

In addition, the notification requirement can alleviate the risk of abusing the contractor's priority right. If contractors do not give timely notice when default occurs, they will lose their security interests thereafter. Consequently, in such cases as stated in section II-B-1 above, owners are not able to collude with contractors to escape repaying construction loans after completion of work.

3. *Other Amendments*

¹²¹ As a more general rule, such notice should be made to any secured creditors whose security interest is perfected earlier.

The more likely banks feel that contractors will exercise their priority right, the better incentive they will have to monitor owners. Thus, actions should be taken to smooth contractors' way of enforcing the priority right. The following proposals are targeted at this goal.

First, many commentators argue that contractors should be allowed to apply directly for auction of construction projects without having to go through the trial proceeding first.¹²² In fact, this is one effect of the contractor's priority right explicitly provided in Article 286. However, as stated hereinabove, courts do not permit this direct execution approach in practice. Skipping the trial proceeding certainly saves time and cost for contractors. But under current Chinese civil procedure rules, even if courts permit contractors' applications for direct execution, during the execution proceeding, other interested parties, owners and banks in particular, will still be able to challenge substantive issues of the priority right, amount of construction price or defects in construction work, for example. Once such challenges appear, courts may have to stay execution and make judgments over these substantive issues first. For this sake, I wonder whether the direct auction could bring material difference to contractors. Doubtful as I am, considering the time-sensitiveness of the payment of construction price, certain kind of simple procedures might be needed to enforce the contractor's priority right.

Second, profits should also be protected by the contractor's priority right. As business entities, contractors' main purpose of engaging in construction projects is to make profits. From their perspective, a security interest will be of little business value if it does not secure profits.

¹²² See, e.g., Yonglong Ma & Yan Li, *Jian Zhu Gong Cheng Kuan You Xian Shou Chang Quan Fa Lü Shi Yong Wen Ti Tan Xi* [Probing the Problems in Legal Application of the Contractor's Priority Right], 6 *Xian Dai Fa Xue* [Modern Law Science] 127, 129 (2003); Zeng, *supra* note 21.

The contractor's priority right cannot best protect laborers if it is designed purely as a legal institution for laborer-protection. And any attempt to differentiate (laborer's) living interest with (contractor's) business interest,¹²³ as it seems to me, is far from promising. In fact, no living interest – laborers' wages – can survive if the contractor's business collapses. The real point is to explore and make the best use of potentials of the contractor's priority right, so that everybody involved in the construction project could be better off.

Finally, it deserves a second consideration whether completion should remain as a pre-condition to enforce the contractor's priority right. On the one hand, as stated above, the completion requirement invokes substantial disputes in interpretation and is incompatible with the practice in construction industry. So it may stand in contractors' way to enforce their priority right. On the other hand, it can be more difficult to sell construction projects before completion and probably at much lower price, thus not in the contractor's best interest to conduct pre-mature enforcement. However, it seems that the degree of either aspect varies from case to case. Accordingly, we'd better let contractors make the decision whether the priority right should be activated before completion.

IV. CONCLUSION

The contractor's priority right may help curb the amount of defaulted payments to contractors, but perhaps not in a significant way. When the construction project has limited

¹²³ This differentiation seems to play a role in determining the scope of the construction price protected by the contractor's priority right (*see* Wang, *supra* note 17, at 65).

liquidity in the open market, the contractor may not be able to sell or otherwise convert it into monetary value when the owner defaults in payment. The current framework of this priority right, delineated by Article 286 and the Supreme Court Interpretation, still has room for improvement to better achieve its desired effect where it does work.

The contractor's priority right, above all, gives direct protection to contractors and it should be geared to do so. Laborer-protection is no more than a derivative effect. So the efficiency of this system should not be compromised by the laborer-protection objective. Indeed, there are many other measures that can provide more direct and efficient protection to laborers, such as the social security system.

The contractor's priority right does not function simply by shifting the loss from contractors to banks. Scarcely any existing fairness argument can convincingly justify such a redistributive function. The merit of this system, nevertheless, depends on its overall efficiency in reducing risk alteration and monitoring costs. Therefore, it should be designed in a way to incentivize banks to monitor, as they are best equipped to prevent owner's misbehaviors at the lowest cost.

Some scholars predicate that the priority right system should be adopted by the Chinese Civil Code now being drafted, like the Japanese Civil Code.¹²⁴ This theory advocates granting statutory liens to certain special creditors, on debtors' specific properties or their general assets. As for these creditors, the "first in time, first in right" rule does not apply. In fact, the contractor's

¹²⁴ Professor Liming Wang is a representative (*see* Liming Wang as editor-in-chief, *Zhong Guo Wu Quan Fa Cao An Jian Yi Gao Ji Shuo Ming [A Proposed Draft of PRC Property Law]* (2000). For a recent study on the priority right system under Chinese law, *see* Mingrui Guo, *You Xian Quan Zhi Du Yan Jiu [A Study on the Institution of Priority Right]* (2004).

priority right is but one kind of such priority rights. Yet risk alteration and monitoring inspiration might be the general effects of any kind of priority rights, which amounts to an exception to the rule of “first in time, first in right”. The influences of these effects, however, tend to vary in different situations associated with each kind. When the cost-effective monitoring stimulated by a particular priority right is not enough to offset the intensified problem of risk alteration, adopting this priority right can lead to a social loss. The justification, asserted in this paper, for the contractor’s priority right might be inapplicable to another priority right. But a cost-benefit study should always be done before any priority right is to be adopted. Moreover, once the right is adopted, follow-up studies should be conducted to track its functioning in reality and adjust the legal rules when necessary. I hope this paper could also be regarded as a case study on the necessity of a broader priority right system in the forthcoming Chinese Civil Code.