

Chinese Civil Code: impact on guarantees and security

By Raymond Cai

An article to discuss the Chinese Civil Code's impact on the laws of guarantees and security.

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After a number of years of consultations and debates, the long-awaited Civil Code of the People's Republic of China (2020 Civil Code, or the Code) was eventually adopted by the 13th *National People's Congress* on 28 May 2020, and will take effect from 1 January 2021. Concurrently with the entry into force of the Code, the PRC Security Law 1995 (1995 Security Law) and the PRC Property Law 2007 (2007 Property Law) (that is, the primary laws currently governing guarantees and security) will cease to be effective on 1 January 2021.

The Code brings a fundamental change to the legal regime of guarantees and security. Generally, as compared to the 1995 Security Law and 2007 Property Law, the Code reiterates the dependency of guarantees and security and appears to be much friendly to guarantors and security providers. The shift of the top legislature from a creditor-friendly position to favouring guarantors and security providers would probably make it more difficult for creditors in conducting financial transactions. It remains to be seen how the new rules would be applied in practice and what impacts they would bring to the financial industry.

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Implications on guarantees

The 2020 Civil Code makes a series of significant changes to the law of guarantees.

Providing liberty for consensus between contractual parties

The guarantor should become liable upon occurrence of circumstances agreed by the contractual parties (*Article 681, 2020 Civil Code*). This means the contractual parties have the liberty to agree on a broader range of circumstances which may give rise to the guarantee liability. Previously, in most scenarios, the creditor was entitled to call a guarantee only in the case where the guaranteed indebtedness fails to be satisfied.

Emphasizing the ancillary nature of guarantees

It is a general rule under PRC law that a guarantee is ancillary to the guaranteed indebtedness in the nature, which means the guarantee is always dependent on the underlying indebtedness. Where the guaranteed indebtedness becomes invalid, the guarantee will become invalid accordingly. It has been arguable in practice for a long time whether the contractual parties may exclude this general rule and otherwise agree to the independency of a guarantee. In contrast with Article 5 of the 1995 Security Law, the 2020 Civil Code emphasizes the ancillary nature of guarantees by deletion of such exclusion as agreed between the contractual parties. The general rule can now only be excluded if the law provides otherwise (*Article 682*).

Recently, the *Supreme People's Court* issued a draft for consultation in respect of judicial interpretations regarding the security part of the 2020 Civil Code, which provides that only a bank or non-bank financial institution is allowed to provide an independent guarantee, the validity of which has nothing to do with that of the guaranteed indebtedness.

Extending statute of limitations for general guarantees

Under the 2020 Civil Code, the statute of limitations for a general guarantee commences from the date on which the guarantor ceases to have the right to refuse to assume the guarantee liability (*Article 694*). This in fact extends the statute of limitations for general guarantees. Previously, the period commenced from the effective date of the relevant judgment or arbitration award.

Offering more protections to guarantors

The 2020 Civil Code is viewed as guarantor friendly, in particular in the following aspects:

- Where it is silent or not explicitly stipulated as to the means of guaranty in a guarantee, such guarantee should be construed as a general guarantee (*Article 686*). Previously, in that context, the guarantor should undertake the liability on a joint and several basis. Obviously, this change may relieve the liability of the guarantor as the guarantor can defend by requesting the creditor to first claim against the debtor.
- Where it is not explicitly stipulated as to the duration of guaranty in a guarantee, the duration of guaranty

should be construed as six months (*Article 692*). Previously, the duration of guaranty was two years in that context. The shortening of the duration of guaranty will benefit the guarantor.

- The guarantor is granted a right of subrogation against the debtor after discharge of its guarantee liabilities, which will expedite the guarantor to recover from the debtor to the extent of guarantee liabilities (*Article 700*).
- The guarantor may defend against the creditor where the debtor has the right of set-off or withdrawal against the creditor (*Article 702*).
- The creditor should notify the guarantor when it transfers the claim, failing which, the transfer will not become effective or binding against the guarantor (*Article 696*).

Implications on security

The 2020 Civil Code does not significantly revise the provisions of the 2007 Property Law, but it still contains a range of adjustments and improvements.

Expanding categories of security

Apart from those typical security, such as mortgages, pledges, security deposits and liens, as stipulated in the 1995 Security Law and the 2007 Property Law, the 2020 Civil Code explicitly recognises other types of contract having the same effect of security (*Article 388*), such as financial leasing, factoring, and retention of ownership. This is a breakthrough for the doctrine of statutory property rights (物权法定主义), which will definitely give transaction parties much more flexibility in creation of security rights. Furthermore, it is clearly stipulated that existing and future account receivables can be the subject matter for a pledge (*Article 440*).

Reforming property right registration system

The 2020 Civil Code does not mention the governmental authorities in charge of registration of pledges over movable properties and rights, which will facilitate establishment of a consolidated pledge registration system in the near future.

Adjusting ranking rules for security

The ranking of security should be determined by virtue of the “first in time” rule regardless of categories of security (*Article 414*), subject to the following exceptions:

- A lien has priority over a mortgage or a pledge (*Article 456*).
- A mortgage which is created as security for payment of the purchase price of a movable property has priority over other security rights (but ranking behind liens) (nicknamed “super priority”) (*Article 416*).

Changing position towards Liuzhi and Liuya

Instead of directly prohibiting Liuzhi (流质) and Liuya (流押), the 2020 Civil Code requires the pledgee or mortgagee to get paid in priority to the extent of the pledged or mortgaged assets (*Articles 401 and 428*). By

taking such approach, the Code appears not to deny the validity of provisions as agreed between the contractual parties in respect of Liuzhi and Liuya and rather reiterates the recovery should be strictly limited to the amount of indebtedness, which in fact discourages the title transfer of the subject property through an up-front agreement.

The term “Liuzhi (流质) or Liuya (流押)” is a unique concept under continent law, which literally means the contractual parties agree in advance that the ownership of the pledged or mortgaged assets will be transferred to the creditor directly for the purpose of satisfaction of indebtedness once the debtor fails to fulfil the obligations. Such agreement was previously prohibited due to unfairness.

Abolishing prohibition upon transfer of mortgaged assets

The 2020 Civil Code permits assets subject to mortgage to be transferred without restrictions (*Article 406*), which lifts the long-time prohibition imposed by the 2007 Property Law. However, the mortgage should subsist and remain binding upon the transferee.

Fine-tuning relationship between tenancy and mortgage

To safeguard the interests of the tenant under a tenancy entered into before registration of a property mortgage, the 2020 Civil Code largely follows the same approach as taken by the 2007 Property Law by entitling the tenant to defend against the mortgagee, which means the tenancy remains effective and binding upon the mortgagee or transferee or acquirer of the property as a result of enforcement of the property mortgage. However, to avoid misuse of this defence, the tenant is required to have taken possession of the property (*Article 405*).

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