

The adoption of the Chinese Civil Code and its implications for the law on guarantees and security in China

At a Glance...

On May 28, 2020, China's top legislature, the 13th National People's Congress, passed the long-expected Civil Code of the People's Republic of China (the Civil Code), which will take effect from January 1, 2021. A general introduction to the Civil Code can be found in our [client alert](#) dated June 3, 2020.

Among the changes, the Civil Code has made changes and improvements to the law on guarantees and security, which will be the focus of this article.

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Overall framework and terminology

Under the current legal framework, the Security Law of the People's Republic of China of 1995 (the Security Law) and the Property Law of the People's Republic of China of 2007 (the Property Law) govern security (担保). By definition, "security" is comprised of guarantees (保证), mortgages (抵押), pledges (质押), possessory liens (留置) and security deposits (定金). To the extent there is any inconsistency between the provisions of the Property Law and the Security Law in respect of security over assets (a legal concept covering mortgages, pledges and possessory liens), the provisions of the Property Law prevail.

Upon the Civil Code taking effect, the Security Law and the Property Law will be repealed. The Civil Code thus consolidates the Security Law and the Property Law, and codifies or lays down the legislative framework in this area of law. We set out below a summary of some of the key changes and clarifications made by the Civil Code in this area of law.

Key changes	Current position	New position
1 . Security over assets		
1.1 Expansion of the types of security over assets	The security contracts over assets under current laws mainly specifically include mortgages and pledges.	Article 388 of the Civil Code provides that security contracts include mortgages, pledges and other contracts that have the function of security . The expanded definition of "security contracts" provides the legislative space for the PRC judiciary to recognize more "atypical security contracts." For example, acting in its legal capacity, the PRC judiciary has gradually recognized ¹ new types of security contracts, one such example being assignments of assets by way of security, while currently the Property Law only provides for three types of security contracts in respect of assets: mortgages, pledges and possessory liens.
1.2 Mortgages permitted to transfer mortgaged assets	The existing law stipulates that a mortgagor may only transfer mortgaged assets with the mortgagee's consent. ²	Article 406 of the Civil Code will change the current legal position as follows: <ul style="list-style-type: none"> • The mortgagor may transfer mortgaged assets during the term of the mortgage without affecting its validity. • The parties may, however, contract out of this "default" position. • The mortgagor should promptly notify the

mortgagee of such transfer.

- The mortgagee may only request the mortgagor to prepay the debt with the sale proceeds, or use the proceeds as security, if there is evidence that such transfer could impair the mortgaged assets.

Since any transfer of mortgaged assets would likely increase mortgagees' risks and administrative costs, mortgagees may wish to consider the inclusion of prohibitions against the disposal of assets in their mortgage contracts.

For **pledged rights** (such as a pledge of receivables and shares), the law remains that these generally **not** transferrable by the pledgor except with the pledgee's consent.³

1.3 Change in priority of pledges and mortgages over moveable assets

Previously, the Judicial Interpretation of the Supreme People's Court on Some Issues Regarding the Application of the Security Law of the People's Republic of China (2000) (the Interpretation of Security Law) stipulated that, if a moveable asset was both mortgaged and pledged at the same time, the mortgage has priority over the pledge.⁴

The legal position was recently changed by the Minutes of the 9th National Courts Civil and Commercial Adjudication Work Conference (the Conference Minutes) (issued by the PRC Supreme Court on November 14, 2019), which state that priority should instead be given to the first to be registered, in the case of mortgages, and the first to be delivered into the pledgee's possession, in the case of pledges, thus putting pledges on a more equal footing with mortgages.⁵ The new legal position was also adopted under Article 415 of the Civil Code.

When taking security over moveable assets, mortgagees will routinely wish to check, at the outset, whether the asset is in the mortgagor's possession, likewise mortgagees will wish to ensure that the mortgage is registered as soon as practicable after execution of the mortgage contract. Pledgees are meanwhile advised to check if a registered mortgage is attached to the proposed moveable asset for the pledge and to take possession of the pledged asset as soon as practicable.

1.4 Protection of mortgages securing purchase price of moveable assets

N/A

The Civil Code will create a "super-priority" for mortgages securing the purchase price for the moveable property. Under Article 416 of the Civil Code, where a mortgage is created over a moveable asset in favor of the seller/lender (mortgagee) who finances the payment of the purchase price for such moveable asset, and if the mortgage is registered within 10 days of delivery of the moveable asset to the mortgagor/purchaser, then that mortgage will have priority over all other security interest created over the asset with the exception of possessory liens.

The purpose of this new provision is to protect the seller or lender, and may have been influenced by the standardized business regulations applicable to "purchase-money security interests" under Article 9 of the Uniform Commercial Code, which has been adopted by most states in the United States.

When taking security over moveable assets that are new, mortgagees/pledgees are advised to check the date of purchase and conduct a search to determine whether a purchase price mortgage is registered and, if appropriate, require evidence, representations and/or undertakings that the purchase price has been paid in full.

1.5 Future receivables may be pledged

N/A

Article 440 of the Civil Code provides that pledges may be created over both present **and future** receivables. This gives further clarification to Article 223 of the Property Law, which does not specify whether future receivables may be pledged.

1.6 Clarification on the

Currently, Article 190 of the

To address this, Article 405 of the Civil Code further

protection of existing leases from subsequent mortgages	Property Law stipulates that an existing lease over an asset will not be affected by a subsequent mortgage. However, in practice, it is often difficult for the mortgagee to determine whether or not the asset has in fact been leased.	requires that the incumbent lessee must also have possession of the leased asset in order to be protected. From the lessee's perspective, it is therefore important to take possession of the asset as soon as possible after the lease agreement has been entered into.
1.7 Are security registration reforms on the horizon?	Currently, different types of security are registrable with different government authorities designated under various provisions of the Security Law and the Property Law, and registration authorities have been designated for only limited common and typical security (such as property mortgages, share pledges, pledge over accounts, vehicles, intellectual property rights). ⁶ In practice, though, atypical security contracts cannot be registered due to the absence of a designated registration authority and such a decentralized registration system has made it difficult for third parties to conduct security searches.	In this regard, the Civil Code merely states that mortgages and pledges over rights are registrable, ⁷ leaving the details (including the identities of the relevant registration authorities) to be provided in subordinate legislation. Despite the clear need for a centralized security registration system, it remains to be seen whether further efforts will be made by the PRC to establish a centralized security registration system for all registrable security interests.

2. Guarantees⁸

2.1 Designation of general guarantee as default legal position	Currently, if a guarantee agreement does not state, or fails to clearly state, the type of guarantee covered, then it will be a joint-liability guarantee by default. ⁹	<p>The legal position will change under Article 686 of the Civil Code, which instead designates general guarantees as the default.</p> <p>As with the Civil Code, the main difference between general guarantees and joint-liability guarantees is as follows:¹⁰</p> <ol style="list-style-type: none"> 1. General guarantees: The guarantor is only liable to pay if the debtor cannot pay after granting of a court judgment or arbitral award, subject to limited exceptions (e.g., with regard to surety). 2. Joint-liability guarantees: The guarantor is liable to pay whenever the underlying debt is not paid when due (i.e., the guarantor acts as a primary obligor). <p>Given that general guarantees are less favorable to creditors than joint-liability guarantees, creditors are advised to consider at the outset the type of guarantee they have in mind and, if the guarantee is to be a joint-liability guarantee, this should be expressly stated in the guarantee agreement.</p>
2.2 Default guarantee period conformed to six months	Currently, the Security Law and the Interpretation of Security Law stipulate different guarantee periods for different situations: six months if the guarantee period is "not stated" in the guarantee agreement, and two years if it is "not clearly stated." ¹¹	Article 692 of the Civil Code establishes a single guarantee period of six months for both situations, which makes more sense. In any event, creditors are advised to ensure that (a) the guarantee period is clearly stated in the guarantee agreement and (b) claims are made against the guarantor (for joint-liability guarantees) or court/arbitration proceedings are commenced against the debtor (for general guarantees), in each case within the guarantee period. ¹²
2.3 Extension of statute of limitations for general guarantees	Currently, the statute of limitations for general guarantees commences on the effective date of the court	To resolve this conflict, Article 694 of the Civil Code instead stipulates that the statute of limitations shall commence when the guarantor is liable to pay the underlying debt, which is interpreted to be the point in

judgment or arbitration award against the debtor.¹³ This has been criticized as being illogical, because it means that the litigation period starts ticking before the guarantor is even liable to honor its guarantee obligations (see paragraph 2.1 above).

time when the underlying debt cannot be fully repaid even after the creditor has obtained and enforced a court order or arbitration award against the debtor and its assets. This new legal position appears to be more reasonable, and will better protect a guarantor's interests.

2.4 Assignor of underlying debt to notify guarantor of assignment

Currently, if a creditor assigns the underlying debt to a third party, the guarantee will also be assigned at the same time.¹⁴

Article 696 of the Civil Code clarifies that the assignment must be notified to the guarantor in order to be effective, and also implies that such obligation to notify falls upon the **assignor**. Assignees are therefore advised to require the assignor to notify the guarantor of the assignment.

2.5 Removal of guarantor's right to claim against other joint-liability guarantors

Currently, a guarantor that has honored its guarantee obligations will have subrogation rights against the debtor, as well as the right to claim against other joint-liability guarantors.¹⁵ However, for debts secured by both guarantees and security over assets, a guarantor may only claim against the debtor, but not against other guarantors or security providers, unless otherwise agreed in the guarantee agreement.¹⁶ Such differential treatment does not appear to have any clear rationale and seems to be the result of a conflict between the old and new legislation.

Articles 392 and 700 of the Civil Code clarify that in both situations, a guarantor only enjoys subrogation rights against the debtor, unless otherwise agreed by the parties. Guarantors are therefore advised to specify in the guarantee and other applicable agreement(s) that it will have subrogation rights against other guarantors or security providers, in addition to the debtor.

Conclusion

For a long time, the law on guarantees and security in China has been somewhat haphazard, complicated and, on occasion, conflicting. This has occasionally caused problems in legal interpretation and application, and has often been the subject of debate among legal scholars and professionals. The promulgation of the Civil Code will have the positive effect of providing certainty and clarity. It will go some way towards modernizing this area of law so that it is more in line with international practice.

As noted above, the enactment of the Civil Code is not a once-and-for-all undertaking, and subordinate legislation, legal interpretations as well as judicial opinions are expected to follow in due course.

The Supreme People's Court recently announced its plan to finalize its interpretation of the Civil Code by the end of 2020.¹⁷

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1. The latest judicial opinion on this topic is reflected in Articles 66-71 of the Minutes of the 9th National Courts Civil and Commercial Adjudication Work Conference (the Conference Minutes) (issued by the PRC Supreme Court on November 14, 2019).
 2. Property Law, Art. 191.
 3. Civil Code, Arts. 443-445.
 4. Interpretation of Security Law, Art. 79.
 5. Minutes of Conference, Arts. 64 and 65.
 6. Security Law, Art. 42; Property Law, Arts. 189, 226-228.
 7. Civil Code, Arts. 402, 403, 441, 443-445.
 8. For the purpose of this Article, "guarantees" do not include independent guarantees issued by banks or non-bank financial institutions.
 9. Security Law, Art. 18.
 10. Civil Code, Arts. 687, 688.
 11. Security Law, Arts. 25 and 26; Interpretation of Security Law, Art. 32.
 12. Civil Code, Art. 693.

13. Interpretation of Security Law, Art. 34.
14. Security Law, Art. 22.
15. Security Law, Art. 12.
16. Property Law, Art. 176 and the Minutes of Conference, Art. 56.
17. Notice by the General Office of the Supreme People's Court of Issuing the Plan of the Supreme People's Court for Initiation of Judicial Interpretations in 2020 (最高人民法院办公厅关于印发《最高人民法院2020年度司法解释立项计划》的通知).

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