

# **L**egal Issues on Guarantees in China

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In recent years, along with the rapid development of the economy of the People's Republic of China and due to the progress China has made in the field of legislation on banking security, foreign banks and financial institutions have developed more and more China-related financing projects.

*The General Principles of Civil Law 1986 and the 1993 amendment to the Economic Contract Law as well as the relevant judicial interpretations all show that there are two types of guarantees in China, depending on the wording of the contract<sup>1</sup>. The Security Law 1995 continues to make a distinction between two types of guarantees. It expressly provides for general guarantees and joint and several liability guarantees.*

## **General Guarantee**

A general guarantee is defined as a guarantee which states that the guarantor shall pay and satisfy the guaranteed debt should the debtor fail to pay.

If a lender obtains a general guarantee, the lender is obliged to first exhaust all causes of action against the borrower before having recourse to the guarantor. The guarantor is not obliged to honour the guarantee until a judgment or arbitral award has been made against the borrower and enforcement of such judgment is insufficient to discharge the principle debt.<sup>2</sup>

## **Joint and Several Guarantee**

A joint and several liability guarantee does not refer to a guarantee whereby a guarantor and other co-guarantors are jointly and severally liable for the secured obligations. It refers to a guarantee which contains a stipulation that the guarantor and the borrower (the principal debtor) are jointly and severally liable for the principle debt. Under such a guarantee, a lender is not required to first claim against the borrower before enforcing the guarantee against the guarantor.<sup>3</sup>

For this reason, lenders prefer the joint and several liability guarantee to the general guarantee. To ensure that the guarantee obtained is a joint and several liability guarantee, the lender should

ensure that the **guarantee contract** includes a clause providing for the joint and several liability of the guarantor and the principle debtor.

## **Approval and Registration of Guarantees**

According to the relevant regulations, all China-registered companies and enterprises (with the exception of enterprises with foreign investment) may not take out foreign loans unless prior approval is obtained from the State Administration of Exchange Control (SAEC). Further, after the loan agreement is executed, it must be registered as a foreign debt with the SAEC's local branch within the stipulated period.<sup>4</sup>

Similarly, the *Regulation on Foreign Exchange Control* (promulgated on 29 January 1996) and the Administrative Measures on the *Issue of Foreign Exchange Guarantee by Domestic Organisation* (AMFEGDO) (promulgated in 1991), provide that if a domestic organisation issues a foreign exchange guarantee for the debt of another domestic organisation, prior approval from the SAEC's local branch must be obtained.

Prior approval from the SAEC must also be obtained if a domestic organisation issues a foreign exchange guarantee for the debt of a Chinese enterprise abroad, or a foreign organisation or a wholly foreign-owned enterprise established within or outside the PRC. In addition, foreign exchange guarantee registration must be carried out with the SAEC's local branch by the guarantor within a stipulated period after the issuance of the guarantee.<sup>5</sup>

Failure to obtain the required approval for the foreign loan or for the issuance of foreign exchange guarantee will result in the invalidity of the executed loan agreement, as a condition precedent, that the necessary approval and registration requirements are completed before drawdown of the loan.

After the issuance of a foreign exchange guarantee, any variation to the loan agreement can only be made if the guarantor consents to it. In addition, the

guarantor must obtain the approval of the relevant administration of exchange control. A variation without the guarantor's consent and the approval of the relevant administration of exchange control will result in the automatic discharge of all the guarantor's obligations.<sup>7</sup>

## **The Guarantor**

A lender may not obtain a valid and effective guarantee if it is issued by a person who does not have the capacity to act as a guarantor. In China, government authorities may not act as guarantors. Institutions and social organisations for the public good, such as schools, kindergartens and hospitals are also disqualified from acting as guarantors.<sup>8</sup>

Up to now, guarantees obtained by foreign lenders are mainly provided by Chinese legal entities and rarely by individuals. If the guarantee obtained from a legal entity is a foreign exchange guarantee, as aforesaid, the guarantor is required to obtain prior approval from the relevant administration of exchange control.

As the basic criteria for such approval, the AMFEGDO states that the balance amount of foreign exchange guarantees issued by a financial institution, together with the balance amount of its foreign debts, may not exceed 20 times the amount of its own foreign exchange funds. The balance amount of foreign exchange guarantees issued by a non-financial institution may not exceed the amount of its own foreign exchange funds.<sup>9</sup>

Branches or departments of a legal entity (including the branches of banks or other financial institutions) may not act as guarantors as branches and departments are not registered as separate legal entities. However, if a branch of a legal entity is authorised by the legal entity, then such a branch may provide the guarantee on behalf of the legal entity. Where a branch issues a guarantee without the written authority of the legal entity, or beyond the scope of such authorisation, the guarantee contract or the portion that exceeds the scope of the

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authorisation is void.<sup>10</sup>

## Immediate Recourse

In practice, a lender normally requires immediate recourse, upon default for the full amount of the secured debt against the borrower, the guarantor, the mortgagor and the pledger, or any of them, together with the right to take advantage of a suspense account. However, art. 28 of the *Security Law* provides that where an obligation is secured by both a guarantee and an asset, 'the guarantor's liability is limited to the part of the obligation which exceeds the security over the asset.'

Although the above wording is capable of more than one interpretation, a likely possible interpretation is that the guarantor's liability is limited to the part of the obligation that is not satisfied or discharged by realisation of the security over the asset. Based on this interpretation, art. 28 will not only limit the liability of the guarantor, but also result in the lender losing the right of immediate recourse against the guarantor for the full amount of the loan if the loan is also secured by asset.

It would mean that the lender should, before requiring the guarantor to perform the guarantee, first exhaust all its remedies against the secured asset until such asset has been disposed of and the proceeds prove insufficient to discharge the secured debt.

Obviously, art. 28 is detrimental to lenders. It appears that such provisions are mandatory and may not be varied by contract since there is no legal stipulation allowing the relevant parties to do so. Due to such provisions, a possible alternative will be to use the asset as security for the guarantor's obligations. In this way, the lender has the benefit of the asset as security and, at the same time, have immediate recourse against the guarantor for the full amount of the secured debt.

## Terms of a Guarantee

A guarantee is commonly expressed as a continuing security without specifying a specific term. However, if the parties do not agree on the terms of the guarantee, the lender is only entitled to require the guarantor to perform guarantee obligations 'within six months after

the date of expiration of the term of the principal loan.'<sup>11</sup>

There is no interpretation yet as to whether the period of six months will commence from the due date of each instalment or from the final repayment date of the loan. A lender therefore risks losing its rights under a guarantee if it fails to pursue the payment of even one instalment within six months from its due date. In any case, the practice in relation to foreign exchange guarantees is to register the specific term of guarantee with the SAEC's local branch.

To avoid any doubt and to have a longer period of time within which to enforce the guarantee, a lender may choose to agree with the guarantor in the guarantee contract on a specific period as the term of the guarantee such that the term expires on a date which is substantially later than the expected final repayment date of the secured debt.

## Assignment and Amendment of the Principal Contract

According to the *Security Law*, unless otherwise agreed in the guarantee contract, a lender may assign its right under the loan agreement to a third party without obtaining the consent of the guarantor. After assignment, the guarantor will continue to be liable within the original scope of the guarantee.<sup>12</sup> On the other hand, if a lender agrees to the borrower's assignment of the debt to a third party without the written consent of the guarantor, the guarantor's liabilities will be discharged.<sup>13</sup>

As to the amendment of the principal agreement, it has been held in judicial interpretations that if the amendment to the principal contract is made between a creditor and a debtor, without the written consent of the guarantor, the guarantor will not be liable for any increased debt arising from such amendment.<sup>14</sup>

The newly promulgated *Security Law* provides that if the principal contract is amended or altered between a creditor and a debtor without the written consent of the guarantor, the guarantor will be released from its liability unless otherwise agreed in the guarantee contract.<sup>15</sup> These provisions would seem to allow the parties to include a protective clause in a guarantee contract providing that the

guarantor's obligations shall not be discharged or impaired by any amendment to the principal contract made even without the guarantor's prior consent.

However, the AMFEGDO stipulates expressly that the guarantor's consent to the amendment of the principal contract must be obtained, otherwise such amendment will automatically discharge the guarantor's liability.<sup>16</sup> Therefore, a foreign lender should not rely on a clause giving him power to amend the principal contract without the guarantor's consent but should obtain the guarantor's consent before the amendment is effected.

Further, as mentioned earlier, approval from the relevant administration of exchange control for any amendment (an assignment can be construed as an amendment) to the principal contract is also required for maintaining the effectiveness of the foreign exchange guarantee.<sup>17</sup>

1. Article 89(1) of the *General Principles of Civil Law*; art. 15 of the *Economic Contract Law* (amended on 2 September 1993); arts. 5-7 of the *Provisions of the Supreme People's Court on Several Issues Relating to Guarantees in respect of Trial of Economic Contracts Dispute*.
2. Article 17 of the *Security Law*
3. Article 18 of the *Security Law*
4. Article 21 and 24 of the *Security Law*
5. Article 23 of the *Regulations on Foreign Exchange Control*; arts. 3, 6, 7, 10 of the *Administrative Measures on the Issue of Borrowings by Domestic Organisations* (AMFEGDO)
6. Article 7 of the *Administrative Measures on the Issue of Borrowings by Domestic Organisations*
7. Article 9(3) of the AMFEGDO
8. Articles 8, 9 of the AMFEGDO
9. Article 5 of the AMFEGDO
10. Article 13 of the *Company Law*; art. 22 of the *Commercial Bank Law*; arts. 10 and 29 of the *Security Law*
11. Articles 25 and 26 of the *Security Law*
12. Article 22 of the *Security Law*
13. Article 23 of the *Security Law*
14. Article 12(2) of the *Provisions of the Supreme People's Court on Several Issues Relating to Guarantees in respect of Trial of Economic Contracts Dispute*
15. Article 24 of the *Security Law*
16. Articles 3, 6, 7, 10 of the AMFEGDO
17. *Ibid*.

