RELATIONSHIP BETWEEN A SECURITY AGREEMENT AND THE UNDERLYING PRIMARY AGREEMENT – A NEW DEVELOPMENT

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The PRC Civil Code and the Supreme Court Interpretation on Application of the Relevant Security Provisions in the Civil Code (the Interpretation) that came into effect on 1 January 2021 have both altered the position of whether a security agreement can remain valid when the underlying primary agreement is invalid.

The outdated PRC Security Law (1995) had allowed the relevant parties to agree to having a security agreement to remain valid, even if the underlying agreement is found to be invalid. The introduction of the PRC Property Law in 2007 substantially changed this general rule and provided that a security over personal property, real estate, or other property such as shares cannot remain valid if the underlying agreement is found to be invalid. The two laws were repealed by the PRC Civil Code now.

Pursuant to the PRC Supreme Court judgment of [1998] Jing Zhong No. 184, concerning an import agency agreement, it was stated that only a guarantee in a cross-border transaction can be agreed upon by the parties to be effective and valid, even if the underlying primary agreement is invalid. This position was affirmed in the Supreme Court judgment of [2007] Min Er Zhong No. 117 of 26 December 2007, concerning a security arrangement under a loan.

In 2019, the PRC Supreme Court concluded in the Minutes of the National Courts' Civil and Commercial Trial Work Conference that the parties are not free to agree to an arrangement that permits a security agreement to remain valid, when the underlying primary agreement is invalid, except for a demand guarantee issued by a qualified financial institution. This would apply to international, domestic, commercial, and personal transactions.

Under Articles 682 and 388 of the PRC Civil Code, a contract provision is invalid if it provides that the security arrangement is valid and effective, even if the underlying primary agreement is not, unless there is an exception provided for in law. The Interpretation affirmed this general rule but allowed an exception for a demand guarantee issued by a qualified financial institution.

Under the Provisions of the Supreme Court on Several Issues concerning the Trial of Demand Guarantee Dispute Cases (Demand Guarantee) (2020), a “demand guarantee” is a written undertaking issued by a qualified financial institution to a beneficiary, whereby the issuer will pay the beneficiary at the beneficiary's request and upon the production of the required documents by the beneficiary. To qualify, a “demand guarantee” has to stipulate: (a) the documents that must be presented for payment, (b) the maximum amount payable, and (c) any one of the following:

that it is a demand guarantee;

that the International Chamber of Commerce Uniform Rules for Demand Guarantees and other model rules for independent guarantee transactions would apply; or

that, according to the provisions of the demand guarantee, the issuer is only responsible for making payment upon receiving the required documents, regardless of the underlying primary transaction and the relationship between the qualified financial institution and the applicant of the demand guarantee.

As a result of this legislative and judicial development, it is advisable that all existing security arrangements be reviewed accordingly. Going forward, if a security agreement has to subsist and be valid, regardless of the underlying primary agreement, then the parties should consider making that security agreement a demand guarantee.

We will continue to monitor if the categories of exceptions would be broadened through legislative changes or judicial interpretations.

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