

# Research on the Separation of Mortgagee and Creditor

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**Abstract:** Article 179 of China's Property Law refers to the relationship between the mortgagee and the creditor, which clearly stipulates that "the creditor is the mortgagee". According to this article, the mortgagee and the creditor should be the same subject. However, in the judicial practice of real estate mortgage, local real estate mortgage institutions have many restrictions on the mortgagee, resulting in the separation of the mortgagee and the creditor. Does this conflict with the subordination of the mortgage? In this case, how to realize the guarantee function of mortgage? Based on related cases, this paper will understand the subordination and guarantee function of mortgage from a new perspective, and analyze the inconsistency between mortgagee and creditor from the perspective of the separation between mortgagee and creditor caused by real estate mortgage registration.

**Keywords:** Real estate mortgage, Form separation, Affinity of guarantee.

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## 1. The Emergence of The Phenomenon of Separation Between Mortgagee and Creditor

According to Article 189 of China's Property Law, China's chattel mortgage is established when the contract comes into effect, and registration only affects the effectiveness against the third party, so the separation between the mortgagee and the creditor of chattel mortgage is not prominent. This paper mainly discusses the separation between the mortgagee and the creditor of real estate. Regarding the qualification of the mortgagee of real estate, China's Property Law stipulates that "the mortgagee is the creditor", which shows the consistency between the mortgagee and the creditor, but it does not clearly explain the qualification of the mortgagee. In academic circles, it is generally believed that all civil subjects with civil qualifications can be mortgagees. On July 19, 2019, the State Council issued and implemented the Guiding Opinions of General Office of the State Council on Improving the Secondary Market for the Transfer, Lease and Mortgage of Construction Land Use Rights, which stipulated the eligibility of natural persons as mortgagees of real estate. However, in judicial practice, because the provisions on the registration of real estate mortgage in China are mainly concentrated in the Measures for the Registration of Houses and the Measures for the Registration of Land, there are conflicts between some of their legal rules, and the legislative significance of the Property Law has not been well grasped, so the real estate registration agencies in some areas do not agree with the identity of the real estate mortgagee of natural persons. The refusal of the real estate registration agency to mortgage the real estate of natural persons is mainly due to the fact that the private lending behavior with natural persons as creditors is greatly restricted by the current laws in China. According to the second paragraph of Article 221 of the Contract Law of China and Article 6 of Several Opinions on the Trial of Lending Cases by People's Courts (Fa Min [1991] No.21) issued by the Supreme Court, the regulation of the natural person lending contract by the above regulations may make the lending contract invalid. The real estate mortgage registration agency also has doubts about the mortgage established on the premise of distrust of the main contract

with natural persons as creditors.

The wrong understanding of relevant laws by real estate registration agencies and the consideration of their own interests lead to the failure to register mortgages with natural persons and non-financial institutions as mortgagees, which affects normal economic activities, damages the legitimate interests of the parties and violates the development core of socialist economic construction. In order to protect the security of creditor's rights, creditors can only use the third party-enterprises that meet the requirements of real estate mortgage registration agencies-to complete the registration mortgage, which is the main reason for the inconsistency between mortgagees and creditors in the current society. Does the mortgage generated in this case violate the statutory principle of real right? Should it be protected? Based on the separation between mortgagee and creditor caused by the non-acceptance of natural person registration by real estate registration agencies, this paper explores the hidden legal problems behind this problem, with a view to clarifying whether the separation between mortgagee and creditor violates the subordination of guarantee and how to realize the guarantee function in this case.

## 2. Does the Separation of Mortgagee and Creditor Violate The Subordination of Guarantee

Case: A (the lender) signed a Loan Contract with Company B (the borrower). The contract stipulated that A would lend Company B 269.5 million yuan with a loan period of five months. In order to ensure the repayment of debts, Company B took the right to use 500 mu of land under its name as a guarantee, registered the mortgage, and signed a Land Mortgage Contract. Because the local real estate mortgage department is not allowed to mortgage the land use right to natural persons, After B company (mortgagor) and C company (mortgagee) signed two Land Mortgage Contracts, the content of which is to provide mortgage guarantee for the creditor's rights of A in the Loan Contract with ten land use rights under the name of B company. At the same time, Company B and Company C registered the real estate mortgage in the real estate mortgage institution, and obtained the other warrants issued by the relevant local departments,

which stated the mortgage scope of ten state-owned land use rights in the above contract, with Company B as the obligor and Company C as the holder of the other warrants. Later, because Company B failed to repay the debt and interest in time and in full as agreed in the Loan Contract, Company A and Company C took Company B to court, demanding that Company B repay the debt and interest, and giving priority to the repayment of the amount of debt and interest after the auction of the mortgaged state-owned land use right.

The court of first instance held that in this case, although A is a creditor, he is not a registered mortgagee of real estate, and Company C is a mortgagee as stipulated in the Land Mortgage Contract (the second copy) and stated in other regimes, but he is not a creditor of the Loan Contract and does not enjoy the creditor's rights against Company B, so the court of first instance signed it with Company C according to Article 179 of the Property Law of the People's Republic of China. Therefore, the court of first instance found that there was no legal basis for A to claim the priority right of compensation for the relevant land use right based on the Land Mortgage Contract (the second copy) and other registered certificates, so it rejected the applications of A and Company C. A and C refused to accept the judgment of the first instance and appealed to the court of second instance.

According to the ascertained facts, the court of second instance held that the Land Mortgage Contract signed by Company B and Company C was not a separate contract, but an arrangement made in essence to provide protection for private loans between Company A and Company B, and its transaction arrangement reflected the true intention of Party A and Company B to provide guarantee for their loans with relevant land use rights, and did not violate the relevant provisions of Article 179 of the Guarantee Law, nor did it violate the principle of subordination of security interests in essence, so Party A enjoyed the case as a creditor in this case. According to the above reasons, the second instance judged the errors in the application of the law in the first instance and corrected them, and decided that A had the priority of compensation for the relevant land use rights.

The focus of the above case is whether A has the priority to be compensated for the state-owned land use right involved in the Land Mortgage Contract (the second copy). The courts of first instance and second instance have made two opposite judgments on this issue. In fact, this issue contains three hot discussion points in the current security law field: First, does the separation of creditor and mortgagee violate the "mortgagee is a creditor" stipulated in Article 179 of the Property Law? Second, does this identity inconsistency violate the subordination of the guarantee? Third, does this identity inconsistency affect the realization of the mortgage agreed by the parties?

The purpose of mortgage guarantee is to provide a guarantee for the debt-creditor contract. In the legal relationship of mortgage guarantee, the identities of the creditor and the mortgagee are relative, the creditor corresponds to the debtor and the mortgagee corresponds to the mortgagor. In order to ensure that a loan contract will be followed by a mortgage contract, and both contracts point to the same creditor's right, the "creditor is the mortgagee" stipulated in Article 197 of China's Property Law is a confirmation of the subordination of the mortgage contract.

Article 172 of China's Property Law and Article 5 of China's Guarantee Law have clear provisions on the

subordination of security interests, and the establishment of mortgage can give priority to the repayment of the funds sold by the debtor's mortgage when the debtor fails to perform his debts or the agreed situation of realizing the mortgage occurs. The core of mortgage is to give priority to compensation with the value of the mortgaged property, which embodies the connection between mortgage and the creditor's rights secured by mortgage, that is, the subordination of security interest. From the attribute characteristics of mortgage, we can see that the purpose of mortgage is to provide guarantee for creditor's rights, and the mortgage contract must not exist separately from the main contract. As the main contract, the creditor-debtor contract and the mortgage contract all point to the same creditor's right, that is, the obligee of the two contracts-the creditor and the mortgagee-belong to the obligee of the same creditor's right, so it is proper that the creditor and the mortgagee are the same person.

Due to the imperfection of the mortgage registration system, the natural person as the mortgagee in real estate mortgage registration is usually restricted to some extent. In order to protect the legitimate interests of creditors, creditors will entrust a third person with real estate mortgage registration qualifications to sign a mortgage agreement with the debtor. In this case, the mortgage contract signed with the debtor in the name of a third person actually points to the debt between the creditor and the debtor, but the creditor and the mortgagee are still the same person in essence, and there is no substantial separation between the creditor and the mortgagee. Take the above case as an example. First of all, the Land Mortgage Agreement signed by Company B and Company C is not to mortgage the state-owned land use right to Company C, but to provide mortgage guarantee for the loan from Company B to Company A with the land use right, that is, Company B really mortgaged the land use right to Company A. Thus, the Land Mortgage Contract signed by Company B and Company C is not an independent contract, but a subsidiary contract of the Loan Contract signed by Party A and Company B. This kind of behavior is only an expedient measure to solve the problem that the real estate registration authority cannot register the real estate in the name of a natural person, and it does not affect its deep subordinate relationship. Therefore, the separation between the mortgagee and the creditor in this case is not a real separation, but a formal separation, and its essence is still the same as that of the mortgagor and the creditor. On the other hand, the mortgage shall be registered according to the right to use construction land specified in Article 187 (10) of the Property Law, and the mortgage shall be established at the time of registration. Company B and Company C signed the Land Mortgage Contract, and both parties registered the mortgage in the real estate mortgage agency. Externally, this behavior has publicity effect on the third party; Internally, the Land Mortgage Contract signed by Company B and Company C stipulates that the relevant land use right is to guarantee the creditor's rights between Party A and Company B, which is binding on Party A, Party B and Company C internally. In the case that there is no bona fide third party relying on registration to claim rights, the ownership of rights should be determined according to the agreement of the parties. That is, according to the agreement in the Land Mortgage Contract signed by Company B and Company A, Company C is the formal mortgagor, and Party A enjoys the actual mortgage right to the registered land use right and is the actual mortgagee. This also shows that the creditor and the mortgagee are still the same person in essence,

and there is no substantial separation between the creditor and the mortgagee, which does not conflict with the inner spirit of Article 179 of the Property Law.

To sum up, the separation of the mortgagee and the creditor under the above circumstances is not a real separation, but the mortgagee and the creditor are still the same in essence, that is, there is no breakthrough in "the mortgagee is the creditor" as stipulated in Article 179 of the Property Law, and there is no subordination that violates the guarantee.

### **3. Realization of Guarantee Function in The Case of Separation of Mortgagee and Creditor**

Whether the separation between the mortgagee and the creditor affects the guarantee function of the mortgage, that is, whether the inconsistency between the mortgagee and the creditor affects the creditor's exercise of the priority right of repayment of the mortgaged property in judicial practice. According to China's current judicial practice, judges will generally make different judgments according to whether the mortgagee and the creditor are separated in form or in essence. Just as in the above cases, the creditor proved that the loan contract signed by the creditor and the debtor and the mortgage contract signed by the debtor (mortgagor) and the third party (mortgagee) essentially constitute the relationship between the master contract and the slave contract. The creditor's right is the principal creditor's right secured by the mortgage. The judge of second instance applied the law flexibly, starting from the legislative gist of the property law and the security law, and through the appearance of the separation of the creditor and the mortgagee, explored the true meaning of the parties, and determined the essence of the creditor or the mortgagee. In the case that their identities were inconsistent, the judge of second instance still made a request to support the creditor's priority compensation for the collateral. In addition to the formal separation between the mortgagee and the creditor, there is also the substantial separation between the creditor and the mortgagee in judicial practice. For example, in the case of peer-to-peer lending, the website of peer-to-peer lending asked the debtor to mortgage the collateral to the online loan platform before looking for the lender. When the debtor signed a loan contract with the creditor (lender) in peer-to-peer lending case, the mortgage was registered in the platform name before the creditor's right. When the debtor is unable to perform the debt, the network platform, as the mortgagee, exercises the right of mortgage, enjoys the priority of compensation for the price obtained after the auction of the collateral, and pays off to the creditors in proportion. The problem in the above cases is not only that the registered mortgagee is not a creditor, but that the secured creditor's rights did not exist at the time of mortgage creation. Although the platform has registered the mortgage, the mortgage registration should be based on the actual mortgage. In this case, the platform lacks the actual mortgage foundation, and even if the mortgage registration is handled, the mortgage cannot be realized, which belongs to the substantial separation of the mortgagee and the creditor. The substantive separation between the mortgagee and the creditor's mortgagee has been suspected of breaking through Article 179 of the Property Law, so the request for realizing the mortgage has not been supported. It should also be noted that different judges have different opinions and views on Article 179 of the Property Law, and they also have different views

on whether the separation of the mortgagee and the creditor violates Article 179 of the Property Law. Some judges hold that the separation of the mortgagee and the creditor itself violates Article 179 of the Property Law, and will not consider the conflict between the true meaning of the parties and the imperfection of the mortgage registration system, nor will they further explore whether the identity of the creditor and the mortgagee is substantially separated or formally separated.

To sum up, in judicial practice, when a judge handles the creditor's request for priority in compensation for collateral when the creditor and the debtor are separated, there are generally two ways to deal with it: First, the judge makes a judgment that does not support the creditor's request according to the facts of the case that the mortgagee and the creditor are inconsistent. Second, the creditor proves that the loan contract signed by the creditor and the debtor and the mortgage contract signed by the debtor (mortgagor) and the third party (mortgagee) essentially constitute the relationship between the master contract and the slave contract, and the creditor's right is the principal creditor's right secured by the mortgage, while the judge supports the creditor's request. It can be seen that the separation of the mortgagee and the creditor will affect the realization of the guarantee function to a certain extent, and the creditor is at risk of not realizing the priority right of repayment of the collateral.

### **4. Solution to the Problem of Separation Between Mortgagee and Creditor**

At present, there is no explicit law in our country to regulate the inconsistency between the mortgagee of real estate and the creditor. In judicial practice, only a few judgments of related cases can be used for reference, which is obviously weak to meet the needs of our current judicial practice. The problem of separation between the mortgagee of real estate and the creditor is mainly due to the imperfection of the registration mechanism of real estate mortgage in China. With the rapid development of China's economy, the real estate mortgage system is bound to undergo deep and all-round reform to adapt to the current situation of real estate mortgage in China. On July 19, 2019, the State Council issued and implemented the thirteenth item of "Guiding Opinions of the General Office of the State Council on Improving the Secondary Market of Construction Land Use Right Transfer, Lease and Mortgage", which once again affirmed the suitability of natural persons as real estate mortgagees in China. In addition, in order to solve the inconsistency between the mortgagee and the creditor, and to prevent the mortgage from being invalid due to the formal separation between the mortgagee and the creditor, China urgently needs to take measures at the judicial or legislative level to solve this problem:

#### **4.1. Improve the real estate mortgage registration system**

First of all, Article 12 of China's Property Law and Article 18 of the Provisional Regulations on the Registration of Real Estate regulate the registration of real estate mortgage. However, the above laws do not explicitly require the real estate mortgage registration authority to conduct formal or substantive examination, nor do they stipulate whether the real estate mortgage registration authority needs to review the main contract of the mortgage contract. The current laws in

China aim to require the real estate registration authority to fully perform their duties within their respective responsibilities and register real estate mortgage as accurately and truthfully as possible. Secondly, the registration of real estate mortgage is an administrative act with administrative bureaucracy in China, and the debt contract whose main contract is a natural person may be invalidated by the relevant laws of our country. Real estate mortgage registration agencies are unwilling to bear the risk that the main contract becomes invalid and involves the subordinate contract, so the real estate registration agencies in many areas of our country do not accept natural persons as mortgagees. To solve this problem, we should improve China's real estate registration system from the legislative and judicial levels, strengthen the formal review and substantive review of the real estate registration system, improve China's legal system related to the mortgagee being a natural person, and give more legal protection to the mortgagee of a natural person, which is also conducive to improving the private lending model and promoting the circulation of funds.

#### **4.2. Using anonymous agency system to realize the unity of mortgagee and creditor**

There is a long way to go to improve the real estate mortgage system. Facing the dilemma caused by the separation of the mortgagee and the creditor of real estate, we can temporarily use the anonymous agency system to realize the unification of the mortgagee and the creditor, and reduce the situation that the guarantee function cannot be realized because of the separation of the mortgagee and the creditor. For example, A originally intended to sign a loan contract with Company B, but A could not register the mortgage because of its own identity, so A signed an entrustment agreement with Company C, and then Company B signed a loan contract and a mortgage contract with Company C, and then transferred the borrowed funds to A according to the entrustment contract between A and C. The above behaviors of A and C conform to the structure of anonymous agency, and this form can avoid the problem that the mortgagee and creditor are separated from each other, which meets the requirement that the creditor and mortgagee in Article 179 of

the Creditor Law are one person.

## **5. Residual Theory**

The collision between the development of financial innovation and the traditional legal system has always been a difficult problem in judicial practice, especially when China's property law and real estate system are not perfect, the separation of creditors and mortgagees is the embodiment of this problem. The legal system of each era is influenced by the economic foundation, and the subordination and stability of mortgage are in line with the economic situation during the formulation of mortgage. However, with the rapid development of China's economy, the demand for financial financing has become stronger, and the requirements for the independence and liquidity of mortgage have become higher and higher. While gradually improving the real estate mortgage registration system, we should also think about how to make China's mortgage system more in line with the current economic situation.

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