

Analysis of the Effect of the Liquid Clause in the Civil Code

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Abstract: The Civil Code no longer directly stipulates that the liquid clause is invalid by adopting the legal consequence model for liquid clauses; the softening of the attitude towards the liquid clause is mainly due to the impact of optimising the business environment and the necessity of lifting the ban on the liquid clause. The liquidation of the liquid clause is the realisation procedure of mortgage and pledge in the typical guarantee, and the transfer of the guarantee is represented by the assignment of the guarantee in the case of atypical security, and the realisation of the validity of the liquid clause needs to be based on the principle of attribution liquidation, so as to better realise the value purpose of the liquid clause and ensure the balance of interests between the security right holder and the guarantor.

Keywords: Liquid Clauses; Typical Guarantees; Atypical Warranties; Assignment of Security.

1. Introduction

The so-called liquid clause refers to the agreement between the parties in advance in the guarantee contract that when the debtor fails to perform the debt within the time limit, the collateral will of course belong to the guarantor.[9] The prohibition of liquid clauses is a general principle followed by the civil law of civil law countries; The legislation expressly stipulates that the liquid clause is invalid. China inherits the German civil law, and also prohibits liquid clauses as a general criterion, such as the position upheld by the Guarantee Law and the Property Law, that liquid clauses cannot be stipulated. However, in order to continuously optimise the business environment and enhance China's advantages in attracting investment, the construction of the guarantee system of the Civil Code has been affected by this, and the position on the prohibition of liquid clauses has been changed for the first time. Articles 401 and 428 of the Civil Code no longer provide for the form of "no agreement" to directly prohibit liquid clauses, but to change to legislation in the mode of legal consequences, that is, if the parties agree on a liquid clause, it is no longer directly invalid, but is repaid in priority in accordance with the relevant provisions of the guarantee. The nature of the provisions of the liquid clause has changed from the code of conduct of the Property Law to the norm of the adjudication results of the Civil Code. [5] This reflects the progress of the legislative technology of China's Civil Code, and also shows China's moderate attitude towards liquid clauses.

Although the Civil Code no longer blindly prohibits the attitude of liquid clauses, it does not clearly stipulate the validity of liquid clauses, and the legislator has not expressed its attitude on whether liquid clauses are valid or invalid. Some scholars believe that although Articles 410 and 428 of the Civil Code adopt a softened attitude towards the liquid clause, the essence of the clause is to show that the liquid clause is still invalid, but it does not affect the validity of the security interest. [8] The mortgagee or pledgee can only discount the secured property in accordance with the statutory method or receive priority after liquidation, and the part of the value of the secured property that exceeds the guarantee price shall belong to the mortgagor or pledgee, and the mortgagor

or pledgee shall continue to bear the responsibility for repayment of the part that is insufficient to be repaid. However, some scholars believe that according to the provisions of the Civil Code, the liquid clause is no longer directly invalid, so for the application of the liquid clause, if from the perspective of legal development, the legislative spirit of the Civil Code and the system of security types, the Civil Code seems to be able to be interpreted expansively, allowing the parties to agree on the liquid and obtain the ownership of the subject matter, as long as it is accompanied by a liquidation obligation. [5] Is the legal effect of the provisions of the Civil Code on liquidity invalid, or is the liquidity valid but supplemented by the liquidation obligation? The answer to this question should not only rely on the logical self-consistency of legal interpretation, but also return to the essence and theoretical basis of the liquid clause, and combine the understanding and application of the typical guarantee and atypical guarantee to the liquid clause, so that the conclusion can be more convincing.

2. The Theoretical Controversy over the Liquid Clause

2.1. The Reasons for Prohibiting the Liquid Clause and Its Reflection

As a general principle followed by the civil law of civil law countries, the main reasons for the prohibition of liquid clauses in the academic community are as follows:

The first is to protect the interests of debtors in a vulnerable position, so as to demonstrate the fair value of civil law. One of the strongest reasons since Roman law prohibits liquidity is that in a lending relationship, the debtor is in a vulnerable position and the guarantor obtains the encumbered property in excess of the security price by virtue of its dominant position, which is a manifest injustice. In fact, the assumption that the liquid clause is unfair to the debtor actually sets two preconditions, namely, that the value of the collateral must substantially exceed the value of the claim and that the creditor must take advantage of the debtor's weak position to usurp ownership of the collateral. [19] It can also be understood that when the amount of the security price is not much different from the value of the secured property or the

debtor is not in a weak position, the liquid clause is justified and should not be prohibited.

The second is that the prohibition of liquid quality highlights the essence of the property right, that is, the conversion attribute of the security interest. The essence of the creation of a security interest is to guarantee the repayment of the principal claim, and it is based on the exchange value of the collateral, not to directly obtain the ownership of the collateral. However, "value attribute" is a concept developed from the power and function of a security interest, and it is not necessary to use it as a guideline for security right legislation. [18] Although the liquid clause is manifested as the guarantor obtains the ownership of the secured property, its essential purpose is also to guarantee the repayment of the principal claim, and the liquid clause is only its means, and its value lies in the repayment of the guarantee. Therefore, it is not wise to blindly prohibit liquid clauses.

Third, the prohibition of liquid quality can prevent the loss of state-owned assets. State-owned asset managers abuse the provisions of the liquid pledge clause to use state-owned assets as security, and when the main claim is not repaid as agreed, the guarantor obtains the state-owned assets. However, in essence, the loss of state-owned assets lies in the negligence of the supervision of state-owned assets, and even if there is no liquid clause, there will be other ways to lead to the loss of state-owned assets; therefore, the focus of protecting state-owned assets should be on a sound regulatory system, rather than just on prohibiting liquid clauses.

2.2. The Necessity of Lifting the Ban on the Liquid Clause

The basis of the material materials of social life determines the changes in the legal system. With the gradual development of the economy and globalization of countries around the world, the demand for the efficiency of commercial and trade exchanges and the people's pursuit of the value of freedom, the prohibition of liquid clauses is no longer suitable for its development, and the lifting of the ban on liquid clauses has become an inevitable choice.

2.2.1. Fluidity is the Autonomy of The Parties, and the Law Should Not Interfere

In the security contract, the guarantor and the guarantor choose to agree on a liquid clause, which belongs to the freedom of disposition of both parties; when it is unable to pay the principal debt, the guarantor chooses to relinquish ownership of all of its encumbered property and the guarantor obtains ownership. As to whether the difference between the value of the encumbered property and the amount of the security price is commensurate, this is largely measured by the value of the security right holder and the guarantor; even if the value of the encumbered property is excessively greater or less than the security price, resulting in the loss of the interests of the other party, this is still only a matter of weighing the interests of both parties, and is not a direct reason for determining that the liquid clause is invalid. Moreover, the prohibition of liquid clauses deprives the parties of their free choice in order to realise economic value, which is contrary to the legislative spirit of private law autonomy; therefore, the law should not interfere too much with the agreement of the liquid clause, which belongs to the free expression of the will of the parties

2.2.2. The Lifting of The Ban on Fluid Quality Is Inevitable for The Development of Commercial Efficiency

According to Posner, the basic function of law is to change stimulus from the point of view of economics or wealth maximisation. [17] This kind of legal stimulus is a disguised incentive to promote the prosperity of economic development. For both parties in the vortex of market transactions, based on the consideration of commercial efficiency and the pursuit of profits, agreeing on a liquid clause may be the best choice and the most rational decision. Although mortgages, pledges and other security methods can guarantee the repayment of claims, rather than the cumbersome realisation procedures and the time and economic costs consumed, liquid clauses are likely to be the way for the parties to maximise their value. In addition, whether it is a liquid guarantee or other forms of atypical security, it can play a role in guaranteeing claims and urging the guarantor to actively repay debts, and the most important thing for the parties is not whether the liquid clause prohibits it, but how to efficiently achieve their economic goals through the guarantee to earn profits.

2.2.3. The Lifting of The Prohibition on Liquidated Damages Also Upholds Social Fairness

As mentioned earlier, the fairness value of prohibiting liquidated damage clauses lies in the premise that the value of the secured property significantly differs from the amount of the secured claim, and that the debtor is in a disadvantaged position; it does not consider whether this preset premise exists or whether there are corresponding remedies when unfairness exists. The application of liquidated damage clauses generally occurs between commercial entities of equal standing, where both parties have made decisions based on a confident assessment of their interests regarding the application of such clauses. In a civil society driven by contracts, entrepreneurship, and the freedom to compete for money, one of the beliefs is that people practically and wisely take care of themselves. Any rule that allows judges to declare contracts invalid based on substantial inequality is paternalistic and undermines the certainty of the law. [16] Therefore, in the realm of private law autonomy, the so-called fairness does not only require substantive fairness but also necessitates formal fairness, providing both parties with equal freedom to make decisions during the transaction process, rather than imposing legal restrictions. The embodiment of fairness value can be achieved not only through the route of 'prohibition - invalidation'; the lifting of the prohibition on liquidated damage clauses insists on maintaining the value of social fairness and also reflects the implementation of the principle of freedom.

3. Effect of the Liquid Clause in the Typical Guarantee

3.1. The Provisions of the Civil Code on the Liquid Clause of the Typical Guarantee.

Articles 401 and 428 of the Civil Code: If the mortgagee or pledgee agrees with the mortgagor or pledgee that the mortgaged/pledged property shall be owned by the creditor when the debtor fails to perform the due debts before the expiration of the debt performance period, the mortgagee/pledgee may only be repaid in priority in accordance with the law. This provision does not directly recognise the validity of the liquid clause, but judicial practice

cannot conclude that the existence of the liquid clause violates the mandatory provisions of the law and is invalid based on the Civil Code.

According to the provisions of mortgage and pledge in the Civil Code, the validity of the liquid clause is not clear, so what is the effect of the liquid clause when the parties agree on the liquid clause in the mortgage and pledge guarantee? First of all, as mentioned above, the agreement of the flow clause is the autonomy of the parties, and the law should not interfere too much. Therefore, if the parties agree on a liquid clause in a typical guarantee, as long as the liquid clause is the true expression of the parties' intentions, does not violate the mandatory provisions of the law, does not violate the principle of public order and good customs, and does not have other invalid circumstances, then the liquid clause at this time should be deemed to be valid, is a valid clause in the guarantee contract, and has legal effect.

3.2. The Realisation of The Legal Effect of The Liquid Clause in the Typical Guarantee

According to the above analysis, if the parties have agreed on a liquid clause, as long as the requirements for the validity of the legal act are met, the liquid clause is valid; however, according to the provisions of the Civil Code, the mortgagee/pledgee can only be compensated in priority for the mortgaged/pledged property in accordance with the law, so how can the priority be paid at this time? Can ownership of the encumbered property be directly attributable to the security right holder?

For the realisation of the liquid clause, the Civil Code clearly stipulates that the secured property shall be compensated in priority in accordance with the law; According to the literal interpretation, the so-called "preferential payment" should be understood to mean that the repayment is based on the exchange value of the secured property, and follows the valuation attribute of the security interest. According to the foregoing, the valuation attribute of a security interest is only a concept derived from the value attribute of the secured property, and should not be used as a legislative compass. Therefore, a further understanding of priority should be the satisfaction of secured claims. According to the effective provisions of typical guarantees such as mortgages and pledges, the corresponding publicity requirements must be completed, or registered or delivered before the guarantee can have the corresponding legal effect. At this time, as a part of the security contract, the liquid clause is also effective, so the realisation of the liquid clause should also be realised according to the typical security procedures such as mortgage and pledge. According to Articles 413 and 436 of the Civil Code, the procedures for the realisation of mortgages and pledges are stipulated, that is, the proceeds of the agreement discount, auction or sale are preferentially compensated, and the same is true for the realisation of liquid clauses.

Is ownership of the encumbered property directly attributable to the security right holder? The realisation of the liquid clause in a typical guarantee requires the realisation of mortgage and pledge, which indicates that the ownership of the secured property is not directly attributable to the security right holder, but the repayment of the claim is realised through the agreed discount, auction or sale proceeds; however, this does not mean that the holder of the security right cannot take ownership of the encumbered property. Chen Yongqiang believes that although the liquid contract is valid, it cannot

directly have the effect of ownership attribution, and the effect of the liquid contract is conditional on liquidation, and when the two parties liquidate the value between the creditor's right and the pledge, the ownership of the subject matter can be attributed to the creditor. [5] The scholar believes that the liquid clause is valid but cannot take effect directly, that is, even if the parties have agreed on the liquid clause, but there is an agreed situation for the realisation of the security interest, such as when the secured claim cannot be repaid as scheduled, the security right holder cannot obtain the ownership of the secured property based on the validity of the liquid clause; only through the liquidation procedure, after the value of the secured claim and the secured property is liquidated, the difference in amount is not significant and does not prejudice the rights and interests of both parties, and the security right holder can directly obtain the ownership of the secured property.

4. Effect of Liquid Clauses in Atypical Guarantees: Taking Assignment Guarantee as an Example

4.1. The Provisions of the Liquid Clause in the Atypical Guarantee of the Civil Code

The so-called atypical guarantee refers to a system in which the law does not place it in the creditor's rights guarantee system, or even the law does not stipulate it, but it inherently has or has the function of guaranteeing creditor's rights, and is used for creditor's rights security in social transactions. [6] Atypical security in the narrow sense mainly refers to the form of security for secured claims that has been formed and developed in practice and recognised by judicial precedents and doctrines, represented by assignment of security. According to the first paragraph of Article 388 of the Civil Code, a guarantee contract includes a mortgage contract, a pledge contract and other contracts with security functions; other contracts with guarantee functions incorporate atypical guarantees into the security system of the Civil Code, reflecting the functionalist legislative tendency of the Civil Code. However, the Civil Code does not provide more detailed provisions on the specific system of atypical guarantees, nor does it provide for the liquid clauses in atypical guarantees. With regard to the lack of content in the Civil Code, Article 68 of the Interpretation of Guarantees of the Civil Code stipulates the procedures for the determination of the assignment of security and the realisation of rights, and stipulates that if the assignment of security is publicised, the transferor of the security right will obtain the priority right of compensation, so that the transfer of security system hidden in the Civil Code can be revealed. [7] The effect of the assignment of security is that the debtor transfers the ownership of the secured property to the creditor, and when the debtor fails to perform the repayment of the creditor's rights as agreed, the creditor directly obtains the ownership of the secured property. At this time, the assignment security and the liquid clause are consistent in terms of performance, but the realisation of the security right of the assignment security is not the same problem as the liquid clause; Therefore, when a liquid clause is agreed in the assignment of security, what is the effect of the liquid clause? If the liquid clause is valid, how can the secured claim be satisfied?

4.2. The Realisation of the Legal Effect of the Liquid Clause in the Assignment of Security

4.2.1. Identification and Validity of the Liquid Clause in the Assignment of Security

In the case of a pledge clause, the parties generally agree that if the debtor is unable to repay the debt on time, the ownership of the secured property providing the guarantee is directly vested in the creditor. In the case of assignment of security, the debtor has generally transferred the ownership of the secured property to the creditor, and the liquid clause is generally no longer agreed upon. However, it is possible for the parties to agree that the debtor will lose the right to request the creditor to return ownership of the secured property if it delays the performance of the obligation, or that it will not be able to claim the return of the amount in excess of the secured claim. This kind of agreement, in terms of evaluation, is similar to a liquid agreement, and Article 428 of the Civil Code can be applied by analogy, and its meaning can be transformed into a liquidation agreement. [7] Of course, there are also clauses between the parties that even if the security is assigned, "if the debtor fails to perform the due debts, the ownership of the secured property shall be directly obtained by the creditor". At this time, the liquid clause is valid, but the ownership of the encumbered property has already been transferred to the creditor at the time of realisation of the security right; Therefore, at this time, the effect of the liquid clause is more reflected in the restriction of the debtor's right to later repay and recover the secured property.

4.2.2. Realisation of the Liquid Clause in the Assignment Guarantee

Paragraph 2 of Article 68 of the Interpretation of Security of the Civil Code: "If the debtor fails to perform the debts due, and the creditor requests ownership of the property, the people's court shall not support it; Where a creditor requests that the property be discounted or sold by auction or sale by reference to the provisions of the reference, the people's court shall support it." According to the above provisions, if a liquid clause is stipulated in the assignment of security, the creditor cannot directly obtain the ownership of the secured property based on the liquid agreement, but needs to impose a liquidation obligation to pay off the creditor's rights through the statutory means of discount, auction or sale by agreement. However, in practice, the creditor has already obtained the ownership of the encumbered property through the assignment of security, which is inconsistent with the provision that "the creditor claims ownership of the property". There is a view in the academic community that the transfer of security at this time is "formal ownership" rather than actual ownership, because the real intention of the parties is to achieve the purpose of security by transferring ownership. In the security of the assignment of property rights, regardless of whether the changes in property rights agreed by the parties have been publicised or not, the creditor cannot obtain the real right of the property in substance, but can only be the owner of the property in appearance. [6] Of course, some scholars believe that regardless of whether the assignment of security is publicised or not, the creditor obtains the ownership of the secured property, not the security interest. [7]

In view of the two different views, combined with the provisions of the Interpretation of Security in the Civil Code, the author prefers to transfer the formal ownership of the security, and the creditor only has the ownership of the

secured property on the outside. On this basis, the realisation of the legal effect of the liquid clause in the assignment guarantee also needs to be supplemented by the liquidation obligation. However, it is different from the dispositional liquidation provided for in the security interpretation, and the principle of attributive liquidation should be the principle and the dispositional liquidation should be the exception; This is more in line with the value purpose of the liquid clause, that is, to reduce the cost of realising the security interest and efficiently achieve the purpose of the security.

5. Summary

Articles 401 and 428 of the Civil Code change China's long-standing legislative stance, that is, the attitude of prohibiting liquid clauses, but adopt the legislative provisions of adjudication results, and do not directly stipulate that liquid clauses are invalid. The softening attitude of the Civil Code towards liquid clauses is affected by the continuous optimisation of the business environment, and secondly, because the prohibition of liquid clauses is no longer in line with the value orientation of social and economic development at this stage. According to the legislative spirit of the Civil Code, a liquid clause is valid if it meets the requirements for the validity of a legal act, which is the private law autonomy of the parties and the law should not interfere with it; However, for the effectiveness of liquid clauses, it is necessary to focus on the analysis of typical and atypical guarantees. In a typical security, the effectiveness of the liquid clause needs to be supplemented by the liquidation obligation, and the procedures for realising the security right are the same as those for mortgages and pledges. In the case of atypical guarantees, the assignment of security is the representative, so it is first necessary to identify the assignment of security and the liquid clause; There is a liquid clause in the assignment guarantee, and the realisation of the liquid clause requires the obligation of liquidation, but the attribution liquidation is the mainstay.

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