

# On the Legal Effect of Repayment Type Debt settlement Agreements with Assets

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**Abstract:** In December 2023, the Supreme People's Court issued the "Interpretation of the Supreme People's Court on Certain Issues Concerning the Application of the General Provisions on Contracts in the Civil Code of the People's Republic of China. Article 27 stipulates that an agreement reached by the debtor or a third party and the creditor after the expiration of the debt performance period is a repayment type of debt settlement agreement by means of assets. Corresponding to the "agreement reached before the maturity of the debt performance" as stipulated in Article 28, but in the form of guaranteed debt in kind agreement. The statement in Article 27 that "the people's court shall hold that the agreement takes effect when the parties' expressions of intent are consistent" determines that a repayment type debt settlement agreement is a consensual contract rather than a practical contract. Furthermore, it outlines the selection rules for creditors in scenarios where both new and old debts coexist following the agreement's entry into force, as well as in cases where the debtor defaults on obligations after the expiration of the debt fulfillment deadline. However, how to correctly understand the issue of the right to choose and whether the creditor's claim against the new debt that emerges in practice can exclude the compulsory execution by a third party still need further in-depth exploration.

**Keywords:** Repayment Type; Debt Settlement by Asset; Option Enforcement

## 1. Introduction

"Debt settlement by property" has been a relatively hot topic in recent years. Debt settlement by property refers to the situation where a debtor substitutes another property for the originally scheduled payment, thereby

causing the original debt relationship to be terminated.<sup>[1]</sup> Prior to the Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the General Provisions on Contracts in the Civil Code of the People's Republic of China (hereinafter referred to as the "Interpretation of General Contract Provisions"), issued in December 2023, there was considerable controversy in the practical and theoretical circles over the nature determination of agreements for debt settlement by property, with disputes over the theory of consensual contracts and the theory of practical contracts. After the promulgation of the "Interpretation of the General Rules of the Contract Code", the statement in Article 27 that "the people's court shall determine that the agreement takes effect when the parties' expressions of intent are consistent" clearly stipulates that the repayment type of debt settlement agreement with assets is a consensual contract rather than a practical contract. Furthermore, it stipulates the coexistence of new and old debts upon the agreement's entry into force, as well as the creditor's selection rules in cases where the debtor fails to fulfill their obligations after the expiration of the debt performance deadline. However, how to correctly understand the issue of the right to choose and whether the creditor's claim against the new debt that emerges in practice can exclude the compulsory execution by a third party still need further in-depth exploration.

## 2. Determination of the Nature of Debt Settlement by Means of Assets for Repayment

There are two diametrically opposed views on the nature of a liquidation-based debt settlement agreement. One is the practical contract theory, which holds that after the two parties reach an agreement on debt settlement by property, the delivery of the debt settlement property still needs to be completed for the

agreement to take effect. In judicial practice, many courts also hold this view. For example, in the "Civil Judgment on Retrial of Disputes over Commercial Housing Sales Contract of Li Lin and Guiping Wuxing Real Estate Development Co., Ltd.", the court held that "the substitute payment clause agreed by Wuxing Company and Mingdong Bin to offset the 427,350 yuan of the project payment owed to Mingdong Bin with the C112 shop in this case is a practical contract." Another perspective maintains that the agreement for paying debts in kind constitutes a promissory contract, meaning that it does not hinge on the creditor's actual receipt of payment or acquisition of property rights such as ownership and usage rights over the item used to settle the debt as prerequisites for the agreement's establishment or validity. Provided that the parties' intentions are genuine and do not contravene mandatory provisions of laws and administrative regulations, the contract shall be deemed valid. In the case involving a construction contract dispute between Tongzhou Construction Group Co., Ltd. and Inner Mongolia Xinghua Real Estate Co., Ltd., the Supreme Judicial Court ruled that the agreement for paying debts in kind constituted a new obligation for debt repayment, whereby the old debts remain outstanding until the new obligations are fulfilled; the old and new debts coexist in a state of continuity. The old debt ceases to exist only after the new debt is legally valid and fully performed, as the obligation to repay the debt has been fulfilled. In summary, it is believed that the agreement of debt settlement by asset is a consensual contract. Overall, in the previous long-term judicial practice, the position of the practical contract theory was mainly adopted. Therefore, in the Supreme People's Court Gazette, the "Creditor Subrogation Right Dispute Case between Chengdu Land and Resources Bureau Wuhou Branch and China Merchants (Shekou) Chengdu Real Estate Development Co., LTD., Chengdu Gangzhao Industrial Development Co., LTD., and Hainan Minfeng Technology Industrial Development Corporation" recognized the agreement on debt settlement by property as a practical contract. However, the promulgation of the "Interpretation of the General Rules of the Contract Code" has set the tone for the nature of debt settlement agreements by means of

property. The statement in Article 27 that "the people's court shall determine that the agreement takes effect when the parties' expressions of intent are consistent" defines a repayment type debt settlement agreement by means of property as a consensual contract rather than a practical contract. This means that an agreement on debt settlement by property becomes effective once the intentions of both parties are agreed upon and established. Provided that there are no mandatory provisions that contravene laws and administrative regulations, they shall be deemed legal and valid. This has changed the long-standing position of the practical contract theory in judicial practice and adopted the consented contract theory.

### **3. Whether the New and Old Debts Coexist after the Agreement Takes Effect**

After the agreement on debt settlement by property takes effect, two situations will arise: the first is that the new debt replaces the old one, and the other is that the new and old debts coexist. If the former merely involves a new debt replacing an old one, that is, the new debt is established and the old debt is extinguished, it is similar to the act of substituting for repayment. The latter, in simple terms, means that the establishment of a new debt will not lead to the extinction of an old debt. Both new and old debts will continue to exist together, which is a new debt repayment agreement. In the settlement of new debts, the old debts are not extinguished before the new debts are fulfilled, and the old debts and the new debts are in a state of connection and coexistence. The old debt ceases to exist only after the new debt is legally valid and fully performed, as the obligation to repay the debt has been fulfilled. Based on the principle of protecting creditors' rights, the renewal of a debt typically necessitates explicit consent from the parties involved to extinguish the existing debt. In the absence of such consent, any subsequent agreement reached by the parties for debt settlement in kind, following the expiration of the debt repayment period, shall generally be considered as a new form of debt repayment. In other words, after the expiration of the debt repayment period, if the agreement signed by the creditor and the debtor for debt settlement by means of property does not stipulate the extinction of the old debt, it should be regarded

as an additional performance method for debt repayment by both parties, rather than the extinction of the original monetary payment debt. In short, after a debt settlement agreement with assets takes effect, in principle, the new and old debts coexist, unless the parties have otherwise agreed.<sup>[2]</sup> For instance, in the "Civil Judgment of the Second Instance on the Construction Project Contract Dispute between Shanghai Mingchenghui Industrial Development Co., Ltd. and China Construction Seventh Engineering Division (Shanghai) Co., LTD.", The court held that "since the two parties did not explicitly stipulate in the agreement that the old debts would be extinguished upon signing the agreement for debt settlement in kind, and given that the new debts could not be fulfilled, China Construction Seventh Engineering Division, as the creditor, had the right to request the debtor to continue fulfilling the old debts."

In summary, absent any agreement on modification by the parties concerned, the prevailing judicial interpretation presumes that the agreement for paying debts with assets does not imply an intention of "debt alteration", but merely stipulates a new way of debt performance. At this point, both the new and old debts can coexist, thus raising the question of whether to choose the performance of the new debt or the old one. On the one hand, for the debtor, they can choose between two debts, and the performance of either debt will lead to the extinction of the debt. On the other hand, for creditors, if the debtor does not make a choice on which specific debt to fulfill, at this time, the creditor will have the right to choose in the situation where new and old debts coexist. In conclusion, no matter who has the right to choose, it is premised on the coexistence of new and old debts. Once new and old debts coexist, the issue of option will arise.

#### **4. When a Debt Settlement Agreement with Assets Takes Effect, does the Debtor have the Right to Choose**

Article 27 of the "Interpretation of the General Rules of the Contract Code" stipulates that "If a debtor or a third party fails to perform a debt settlement agreement by means of property as agreed and still fails to perform within a reasonable timeframe despite having been urged to do so, and the creditor chooses to

request the performance of the original debt or the debt settlement agreement by means of property, The people's court shall grant the request." This indicates that in a situation where new and old debts coexist, Only the creditor possesses the right to choose, whereas the debtor has no such right. Most judicial practices before and after the promulgation of this interpretation held this view. In the "Civil Ruling on Retrial Review and Trial Supervision of the Contract Dispute between Yunnan Public Welfare Investment Holding Group Co., Ltd. and Wenqing Li " in 2020, after the agreed period expired, the debtor still failed to perform. When the later period expired, the creditor demanded that the debtor fulfill the "Loan Agreement", and the court supported it. The Civil Judgment of the Second Instance in 2024 concerning Construction Contract Disputes among a Construction Group Co., Ltd. in Jiangsu Province, a Real Estate Development Co., Ltd. in Nanchang, a High-tech Real Estate Development Co., Ltd. in Nanchang, and a Real Estate Group Co., Ltd. In 2024, the court held that "debt settlement by property is a debt of choice. The real estate company chose to deliver the house and the construction company agreed to continue performing it. It is regarded that the face value of the 12 bills has been paid. If the debt settlement by property cannot be fulfilled in the future, the construction company may assert it again.

Professor Liming Wang believes that after the agreement on debt settlement by property is established and takes effect, the debtor has the right to choose to fulfill the old debt or the new debt. It holds that the debt of choice arising after the effectiveness of the repayment type debt settlement agreement with assets should follow the provisions of Article 515 of the Civil Code and go through a "three-step" process. And the debtor's choice of performance of the old debts is beneficial to the discharge of the debts and protects the rights and interests of the creditors<sup>[3]</sup>

#### **5. When the Debtor Fails to Fulfill the New Debt, the Creditor Exercises the Option**

The right of choice is a formative right in nature. The exercise of a formative right by one party will lead to a change in the legal relationship.<sup>[4]</sup> Article 27 of the "Interpretation of the General Rules of the Contract Code"

clearly stipulates that "If a debtor or a third party fails to perform a debt settlement agreement by means of property as agreed, and still fails to perform within a reasonable timeframe despite having been urged to do so, and the creditor chooses to request performance of the original debt or the debt settlement agreement by means of property, the people's court shall support it." This indicates that when a debtor fails to perform a debt settlement agreement by means of property, The creditor has the right to choose whether the debtor fulfills the new debt or continues to fulfill the old debt. From this, it can be seen that if the debt settlement agreement with assets is not fulfilled, the old debt remains valid and its performance can be restored.<sup>[5]</sup> In the "Civil Judgment of the Second Instance of the Property Rights Dispute between Zhang and Meng", the court ruled that "in the event that Zhang failed to complete the transfer of the house to Meng's name as agreed, Meng has the right to choose the method of debt repayment."

Among them, "performing a debt settlement agreement with assets as agreed" means that non performance constitutes a fundamental breach of contract, including partial or defective performance by the debtor constituting a fundamental breach of contract. However, partial or defective performance by the debtor does not constitute a fundamental breach of contract, at this point, the creditor's right to choose has not been completely extinguished, and the old debt has not yet been extinguished. The creditor may request the debtor to continue to perform the outstanding debt obligations.

Some scholars believe that the failure to perform a debt settlement agreement with assets and the breach of the original agreement that generates the old debt constitute two breaches of contract and should bear the liability for both breaches. The author believes that the debtor only needs to bear the liability for breach of contract once and cannot be punished twice for one act. Modern civil law generally holds that the agreement of debt settlement by property should not be regarded as an independent contractual relationship, but merely as a way of debt performance.<sup>[6]</sup> Therefore, a new debt is merely a new way of performance that emerges when the original debt is hindered.<sup>[7]</sup>

When the property used for debt settlement is insufficient to pay off the debt, the creditor's request for the debtor to continue performance and bear the liability for breach of contract should be based on the original legal relationship or the agreement on debt settlement by property. In judicial practice, it is generally held that newly incurred debts cannot be performed, and the old debt should be taken as the standard. The insufficient part should be continued to be performed and the liability for breach of contract should be borne accordingly. In the "First Instance Civil Judgment on the Contract Dispute Between Shandong Yongjia Real Estate Co., Ltd. and Shandong Baibang Real Estate Co., Ltd.", the court held that "the purpose of the property-for-debt settlement clause is to use another asset to offset the original debt, and the portion of the debt settlement clause that remains unperformed does not extinguish the corresponding original debt obligation." For the inability to continue to fulfill the compensation for the remaining properties and the failure to pay the compensation difference corresponding to the unfulfilled part of the debt settlement terms, it violates the provisions of Article 6 of the Agreement constitutes a breach of contract. Baibang Company shall bear corresponding liability for such breach. However, such liability shall be limited to the default obligations arising from the failure to repay the original debt corresponding to the properties not offset under the debt settlement arrangement. Yongjia Company's claim that the price difference loss of the unrepaid houses should be regarded as the actual loss has no factual or legal basis.

## **6. Can the Creditor Exclude the Enforcement by a Third Party**

The crux of the dispute over whether an agreement on debt settlement by property can be excluded from compulsory enforcement lies in whether the provisions of Article 28 of the "Provisions of the Supreme People's Court on Several Issues Concerning the Handling of Objections and Reconsiderations in Enforcement Cases" can be applied.

There is a view that Article 28 does not apply to debt settlement by assets: First, debt settlement by assets is different from sales contracts. Debt settlement by asset aims to eliminate monetary debts, while the core of a

sales contract lies in the buyer's purpose of signing the contract to obtain the ownership of the subject matter. In cases of debt settlement by means of property, the creditor has the right to request delivery and transfer of ownership, but does not need to make further payment. This is because the payment obligation they bear under the sales contract and their claim against the debtor have been extinguished due to offset. The creditor only enjoys the right and does not need to fulfill the payment obligation, thus easily infringing upon the legitimate rights and interests of other parties. Under a contract of sale, the consideration received by the transferor for the subject matter may discharge all indebtedness, thereby ordinarily not prejudicing any third-party rights. The second reason is to consider restricting the scope of application of invisible real rights. The principle of public notice and credibility is a fundamental principle for the change of property rights. However, the expectation right of property rights lacks a method of public notice, and the second party cannot obtain relevant rights information by consulting the real estate register. Granting it the effect of taking precedence over monetary creditors does not conform to the basic principles of civil law such as the equality of creditors and the need for public disclosure of property rights. Thirdly, it is for the consideration of guiding expectations and preventing false litigation.<sup>[8]</sup>

There is also the view that only the type of debt renewal in the debt settlement agreement can be subject to Article 28, excluding compulsory enforcement. Because the alteration of a debt is a contract for the establishment of a new debt and the extinction of an old debt;<sup>[9]</sup> The criterion for judgment is that there must be an expression of intention between the parties to establish a new debt, eliminate an old debt and achieve the modification of the debt.<sup>[10]</sup> The generation of a new debt must be based on an old debt. However, after a new debt is established, its elements and contents are different from those of the old debt, and its legal effects are also different. However, the change of the subject matter of the debt in a debt settlement agreement by asset has an intersection with that in a sales contract. It is precisely the existence of this intersection that enables the agreement on debt settlement by property to be

clothed in the legal guise of a sales contract, thereby meeting the application conditions stipulated in Article 28 of the "Regulations on Objection and Reconsideration in Execution", and thus breaking free from the constraints of the original monetary claim.<sup>[11]</sup> In judicial practice, it is mostly believed that an agreement on debt settlement by property can exclude compulsory enforcement, provided that conditions such as excluding false litigation and the creditor's rights taking precedence over the claims of third parties are met. In the "Second Instance Civil Judgment on Contract Disputes of Shandong Yongjia Real Estate Co., Ltd. et al.", the court held that "the agreement on debt settlement by property does not involve malicious damage to the legitimate rights and interests of third parties or other circumstances, thus avoiding the occurrence of false litigation", and therefore allowed the creditor to request the debtor to deliver the property for debt settlement. In the "Civil Judgment of the First Instance of the Execution Objection Lawsuit by Chen Mou, Ma Mou and other Third Parties", the court held that "the internal subscription agreement signed by a certain company and Chen Mou, although having the external form of a house purchase contract, both parties recognized the true expression of intention as settling debts with houses, that is, the purpose of Chen Mou and the certain company signing the house subscription agreement was not to purchase the real estate in question." Rather, it is to realize the repayment of debts. The time when a certain company signed the internal subscription agreement with Chen Mou was 2020, which was earlier than the time when the house involved in the case was sealed up, that is, 2023. Therefore, Chen's rights take precedence over Ma's creditor's rights and can be lawfully excluded from enforcement.

## 7. Conclusion

The agreement on debt settlement by property has generated considerable disputes and conflicts in judicial practice. The promulgation of the "Interpretation of the General Rules of the Contract Code" has clarified that the agreement on debt settlement by property is a consensual contract, and has stipulated the coexistence of new and old debts after the agreement takes effect, as well as the selection rules governing creditors' options when

debtors default after debt performance deadlines. At the same time, regarding whether the creditor's claim against the new debt can be excluded from the compulsory execution by a third party, judicial authorities make correct judgments based on the specific circumstances of the debt settlement agreement with assets, which is conducive to resolving disputes and conflicts.

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