

Legal Effects of the Exercise of Creditors' Right of Subrogation-- Annotation on the Interpretation Path of Article 537 of the Chinese Civil Code

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Abstract

Since the subrogation system was introduced into China, the legal effect of creditors' exercise of subrogation rights has been a matter of contention, particularly with regard to the interpretation of Article 537 of the Chinese Civil Code. This article analyses the legislative history and judicial practice of subrogation rights in China, as well as the effect of the exercise of subrogation rights from the perspective of comparative law, starting from Article 537 of the Chinese Civil Code. Furthermore, this paper will examine the "rules of warehousing combined with set-off rules", "priority compensation", "restrictive rules of warehousing" and other methods of interpreting the aforementioned irrationality. In conclusion, it was determined that Article 537, Paragraph 1 of the Chinese Civil Code pertains to the "direct compensation rules," while Paragraph 2 pertains to the interpretation of the note provisions.

Keywords

Creditor's Right of Subrogation, Direct Compensation Rules, Rules of Warehousing.

1. Introduction

The formalization of China's subrogation system can be traced back to Article 73 of the former Contract Law of 1999. This article states that "if a creditor is harmed by the debtor's negligence in exercising its due claim, the creditor may request the people's court to be subrogated to the debtor's claim in its own name, unless the claim belongs exclusively to the debtor itself. The scope of the exercise of the right of subrogation is limited to the creditor's claim. The requisite expenses incurred by the creditor in exercising the right of subrogation shall be borne by the debtor." The Supreme People's Court's "Interpretation (I) on Several Issues Concerning the Application of the Contract Law of the People's Republic of China" (hereinafter referred to as the former "Interpretation (I) of the Contract Law"), which was issued in the same year, provides a detailed explanation of the subrogation-related system in Chapter IV, of which Article 20 stipulates the legal effect of the creditor's exercise of the right of subrogation, "The creditor's subrogation lawsuit filed against a sub-debtor is found to have been successful after the people's court hearing. If the people's court determines that the right of subrogation has been established, the sub-debtor shall fulfil the obligation of satisfaction to the creditor, and the corresponding debt relationship between the creditor and the debtor, or between the debtor and the sub-debtor, shall be extinguished." This article is widely regarded as establishing the "direct compensation rules"

Article 537 of the Chinese Civil Code inherits Article 20 of the former Interpretation (I) of the Contract Law and makes several modifications and additions to it. The first modification is the replacement of the term "sub-obligor" with "debtor's counterparty." The second modification is the addition of the phrase "after the creditor has accepted performance" to paragraph 1. This was done to clarify that the enforcement of a judgment does not directly result in the payment

being made, but rather that there is still the step of performance by the debtor's counterparty or enforcement by the court. Furthermore, it was intended to stipulate that only after the creditor has accepted performance would the rights and obligations between the creditor and the debtor, and between the debtor and the debtor's counterparty, be terminated. In the event that the creditor is not satisfied, it may pursue alternative remedies. In this regard, there is pertinent jurisprudence in judicial practice to support this position. In Guiding Case No. 167, the Supreme People's Court held that, in the enforcement of subrogation proceedings, where the enforcement proceedings are terminated because the counterparty has no property available for enforcement, and the creditor separately asserts its rights against the debtor in respect of a claim that has not actually been satisfied, the people's court shall support the claim. Thirdly, a new paragraph 2 has been added to article 537 of the Chinese Civil Code, which stipulates that when a debtor becomes insolvent, or when its rights against its counterparty are subject to measures of preservation or enforcement, the matter shall be dealt with in accordance with the provisions of the relevant laws. This article is a bridging provision between the Chinese Civil Code and the Enterprise Bankruptcy Law and the Civil Procedure Law.

Since China first stipulated the subrogation right system in the former Contract Law of 1999, there has been a divergence of opinion regarding the legal effect of the exercise of subrogation right. The introduction of Article 537 of the Chinese Civil Code has prompted a new round of debate on the legal effect of subrogation rights. Although there are a variety of interpretation paths for Article 537 of the Chinese Civil Code, the fundamental issue remains the support or modification of the "rules of warehousing" and the "direct compensation rules".

2. Doctrinal disputes over legal effects: the “rules of warehousing” and the “direct compensation rules”

The legal effect of the creditor's exercise of subrogation rights has been a topic of considerable debate within the doctrine, with scholars dividing it into two distinct schools of thought: the "rules of warehousing" and the "direct compensation rules". The "rules of warehousing" stipulates that a creditor, who is merely requesting and accepting performance of a debt on behalf of the debtor's counterparty, is not to be remunerated directly in respect of the property it receives. Instead, the creditor is to be satisfied, together with other creditors, after the corresponding property has been placed in the debtor's liable estate, the so-called "warehouse", by the corresponding rules. China's legislation seems to favour the "direct compensation rules", especially after the promulgation of the former Interpretation (I) of the Contract Law, in which the element of direct compensation is more clearly reflected in the law. However, in order to maintain the coordination of subrogation under the system of debt preservation and the equality of debt and other factors, many scholars tend to take the path of "rules of warehousing" interpretation and reform the traditional "rules of warehousing" to some extent, and put forward more convincing reasons. This makes it even more confusing as to how to interpret the legal effect of the exercise of subrogation rights in the context of Article 537 of the Chinese Civil Code. To answer this question, it is advisable to start from the research perspective of comparative law with reference to Chinese judicial practice, and to draw more convincing explanatory conclusions after finding out the antecedents and consequences of the development and evolution of the legal effects of the exercise of the right of subrogation in doctrine, combined with the attitude of judicial practice.

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3. Examination of comparative law

The subrogation system, which is completely foreign to China, was first set forth in article 1166 of the French Civil Code, which provides that a creditor may exercise all the rights and claims of its debtor, except for those rights and claims belonging exclusively to the debtor as an individual. The reason why the subrogation system originated in French law and is not provided for in German law is that, under German enforcement law, a creditor can rely on an enforcement judgment against the debtor to attach the debtor's claim against the debtor's counterparty and transfer it to himself under Sections 828 et seq. of the German Code of Civil Procedure. French law created creditor's right of subrogation in civil law in order to compensate for the lack of a complete civil enforcement system at that time. Article 1166 of the French Civil Code provides for an indirect action, i.e. the creditor has no legal status of his own, but only asserts the debtor's claim in his own name. It can be said that this article originally contained the "rules of warehousing". In order to compensate for the weaknesses of indirect actions, French jurisprudence and doctrine have developed direct actions, whereby the creditor can take measures in his own name against the debtor's counterparty, with the responsibility resting with the creditor himself. This can be seen as a break with the "rules of warehousing" and the system of debt law that it upholds.

Japan inherited the subrogation system of the French Civil Code, and even though it later established a system for enforcing claims by inheriting the enforcement and preservation system of the German law system, the Japanese Civil Code continued the system of creditor's subrogation rights when it was revised. Although the Japanese legislation initially adhered to the "rules of warehousing", which held that subrogation must be exercised on the principle of "subrogation in judgement", jurisprudence later permitted subrogated creditors to receive payments directly from the debtor's counterparties. In 2017, Japan clarified the creditor's right to demand performance from the debtor's counterparty by amending the law, and Article 423ter of the Japanese Civil Code provides that "where the creditor exercises the subrogated right, the creditor may require the counterparty to pay or deliver to the creditor, if the subrogated right is subject to the payment of money or the delivery of movable property. In that case, the subrogated right is extinguished when the counterparty pays or delivers to the creditor". From a doctrinal point of view, Japan has not adhered to the "rules of warehousing", but has developed set-off rules in the field of money and movable property while adhering to part of the "rules of warehousing". After receiving the performance of the debtor's counterparty, the creditor has the obligation to return unjust enrichment to the debtor, which creates a situation in which the creditor and the debtor are mutually indebted. In the case of meeting the aptitude for set-off, the debts of both parties can be set off against each other, thus achieving the effect of the creditor directly from the debtor's counterparty, while enhancing the efficiency of the realization of the claim and avoiding the possible loss of the property after the return of the property to the debtor. At the same time, since the Japanese system of property right amendment is based on the model of intentionalism and registration of counteraction, the emergence of "intermediate omission registration" is not recognised by the academic

community because it violates the real state of property right change by making the entry in the register discontinuous. For this reason, in the field of immovable property, there is no programme that achieves the effect of direct compensation by offsetting.

In conclusion, it can be said that all countries in the exercise of subrogation rights of judicial practice gradually developed in favour of the "direct compensation" legal effect, at the same time, the legislative level also appeared to the traditional "rules of warehousing" breakthrough.

4. Legislative history and judicial practice in China

Chinese judicial practice has always upheld the direct compensation rules. For example, in the Mr Lin and Other Creditors Subrogation Dispute case, the court held that:

the exercise of the right of subrogation will have a preferential effect. The property acquired by whichever creditor exercises the right of subrogation will be attributable to that creditor. This priority of payment, which arises from the commencement of a subrogation action, is based on the nature of the preservation of the debt and is based on the theory that the creditor has contributed to the preservation of the debtor's claim by providing security for the property and contributing to the litigation.

Another example is that in the case of the subrogation dispute between a new building materials company and a construction engineering company, the court held that:

The subject matter of the exercise of subrogation rights is the debtor's claim against the sub-debtor, and the subrogation rights are exercised to obtain individual satisfaction of the creditor's claim. The legislative intent of the subrogation system is to encourage creditors to actively exercise their rights, if the creditor spends time, money and energy to exercise the subrogation right to its debtor's sub-debtor after the lawsuit, but can not directly receive through the subrogation lawsuit to obtain the property, it will make the creditor to lose the incentive to bring subrogation lawsuits, which will make the subrogation system lost the significance of the establishment of the meaning of the subrogation system.

The Intermediate People's Court of Huai'an City, Jiangsu Province, took the same view on this issue, and the Court held that:

The creditor is entitled to directly receive the property acquired through the subrogation action, i.e., although there is no direct relationship of rights and obligations between the subrogator and the subdebtor, the law gives the creditor the right to directly pursue the subdebtor, creating a new relationship of rights and obligations of direct consequence between the creditor and the subdebtor, which the subrogator, once he has filed a subrogation action, can cross over to the debtor and treat the subdebtor as the creditor's debtor.

It can be seen that in judicial practice, courts in all parts of China have recognized that the creditor directly receives the performance of the debtor's counterparty, supporting the "direct compensation rules". This is in line with the legislative interpretation, which aims to mobilise creditors to enforce their claims and to strengthen the protection of the realisation of claims, so that the subrogation system "not only has the preservation function of preventing the reduction of the debtor's liable property, but also achieves the effect of contributing to the realisation of claims to a certain extent".

5. Path of interpretation of article 537 of the Chinese Civil Code

To clarify the effect of the exercise of the subrogation rights of Chinese creditors, it is necessary to centre on article 537 of the Chinese Civil Code. In this regard, academics have proposed a variety of interpretative paths for this article. For example, some scholars believe that Article 537 of the Chinese Civil Code is only an amendment to the "rules of warehousing", but does not really deviate from the "rules of warehousing", and the "termination of rights and obligations"

in paragraph 1 of Article 537 is actually realized by the set-off rules. However, this argument has its own irrationality and is not entirely compatible with the system of the Chinese Civil Code. According to article 568, paragraph 1, of the Chinese Civil Code, debts between parties may be set off against each other only if the subject matter of the debts is of the same kind and quality. This rule of set-off creates difficulties for the creditor in practice in accepting the performance of the debtor's counterparty, and is contrary to the effect of facilitating the fulfillment of claims as required by Chinese legislation. Moreover, the theory of combining the "entry rule" and the set-off system was originally developed by the Japanese academia, as mentioned above, because the Japanese property right amendment adopts the mode of intentionalism and registration confrontation, and the "intermediate omission of registration" will make the entry in the register discontinuous and violate the real state of property right. Therefore, Japanese legislation does not adopt direct performance by the debtor's counterparty to the creditor in the realm of immovable property, which coincides with the state of affairs where the rules of set-off can basically only be applied in the realm of money or movable property. However, China for real estate property right amendment to adopt the registration of the effective doctrine, even if there is "intermediate omission registration" and the real change of property rights fully consistent with the situation, the judicial practice does not exclude the "intermediate omission registration". Also, article 537, paragraph 1, of the Chinese Civil Code does not limit the right of subrogation to the field of money and movable property. Therefore, the model of the "rules of warehousing combined with set-off rules" is not entirely compatible with the system of the Chinese Civil Code. China did not follow the course of the Japanese law on set-off, but stated directly in article 537 of the Chinese Civil Code the desired final effect: the creditor may accept the performance of the debtor's counterparty, and this performance may have the direct legal effect of extinguishing the two claims to the extent of the corresponding claims, without the need to resort to the rules of set-off.

With regard to article 537 of the Chinese Civil Code, some scholars believe that creditors will enjoy the right of "priority compensation", but the author does not agree with the above view. In the first instance, if the debtor's estate is sufficient to satisfy the debt, the creditor may be paid directly if it is a single creditor. This is not because the creditor enjoys priority in terms of substantive rights; rather, it is simply because the creditor was the first to bring an action for subrogation of creditors and thus precedes it in the actual order of payment. In the event that multiple creditors file a subrogation action concurrently and prevail, they are entitled to equal rights to direct payment. However, given that the entry into force of the judgment does not result in direct payment, and that it remains necessary to apply for the execution of the debtor's counterparty's property, the order of payment must be confirmed by the sequence of execution notices issued by the Executive Bureau of the court. If, after the creditor has obtained a judgement in favour of the creditor and before the creditor applies to the court for enforcement, another creditor preserves or enforces the subrogated claim and receives the benefit of the claim in preference to the subrogated creditor. Since a judgement in favour of a creditor on subrogation only confirms and determines the creditor's right to claim performance against the counterparty without interfering with the attribution of the subrogated claim itself, the law still gives priority protection to the creditor who has first taken measures of preservation or enforcement. It follows that subrogated creditors do not have the right of "priority compensation".

In accordance with Article 537, Paragraph 2 of the Chinese Civil Code, in the event that the debtor's liable property is insufficient to satisfy the creditor's debts in full, the matter shall be dealt with in accordance with the relevant legal provisions. Under the provisions of article 2 and article 7, paragraph 2, of the Enterprise Bankruptcy Law, a creditor may apply to the people's court for the debtor to be liquidated in bankruptcy. When the court determines that the debtor clearly lacks liquidity, the debtor enters into appropriate insolvency proceedings, with the

insolvency administrator replacing the debtor as the recipient of performance. According to article 16 of the Enterprise Bankruptcy Law: 'After the people's court accepts the bankruptcy application, the debtor's settlement of debts to individual creditors is invalid.' At this point, the subrogated creditor loses the right to receive payment directly from the debtor's counterparty. In the case of an ongoing creditor subrogation action, the bankruptcy administrator as well as the counterparty may request the court to dismiss the creditor's claim. In the event that a subrogated creditor has secured a favourable judgement prior to the admission of the bankruptcy petition, the counterparty is entitled to lodge a debtor's objection on the grounds of the creditor's loss of substantive competence during the enforcement proceedings. In addition, pursuant to article 32 of the Enterprise Bankruptcy Law, the administrator has the right to request the people's court to exercise the right of bankruptcy revocation if, six months prior to the acceptance of the bankruptcy application by the people's court, there has been preferences of creditors that does not benefit the debtor's property. This means that even if a subrogated creditor has received payments made by the debtor's counterparty, its subrogated proceeds may still be revoked in bankruptcy proceedings. Ultimately, all creditors submit and settle their claims on an equitable basis. The application of the insolvency rules in this context also demonstrates that subrogated creditors do not have the right of "priority compensation". In addition to the aforementioned provisions pertaining to the involvement in the distribution system in the event of an enterprise's bankruptcy, individuals may also refer to the involvement in the distribution system analogous to the bankruptcy system in the event of insolvency. This is done in order to enable all creditors to receive fair compensation for their claims in accordance with the involvement in the distribution system outlined in Articles 506-514 of the Interpretation of the Code of Civil Procedure. In practice, there have been relevant cases to support, in Guizhou new construction industry engineering limited liability company and Chen Jianguang and other creditors subrogation disputes re-examination case, the supreme people's court that:

Article 537 of the Civil Code of the People's Republic of China reflects the jurisprudence of balancing the protection of subrogated rights holders with the equality of claims, and in the event of insolvency of the debtor, the realisation of subrogated rights should be linked to the participation in the distribution system and the insolvency system, in order to achieve a balanced protection of the subrogated rights holders and the other creditors of the debtor. Song Wenping, the creditor in this case, is a natural person and is not eligible for bankruptcy, but when his property is insufficient to pay all of his claims, there is a participatory distribution system similar to that in bankruptcy proceedings to safeguard the fair payment of claims.

It follows that the subrogated creditor does not have a right of "priority compensation" and that the legal effect of the creditor's exercise of the subrogation right is more appropriately described as 'direct compensation'.

According to the author, paragraph 1 of Article 537 of the Chinese Civil Code embodies the "direct compensation rules", while paragraph 2 is a cautionary provision, suggesting that the subrogation system should be combined with the relevant provisions of the Enterprise Bankruptcy Law and the Civil Procedure Law in the application of the law. As for the 'direct compensation rules', some scholars disagree with its jurisprudence, saying that it is not detailed and that the creditor's right of subrogation in the French legal system is called an 'indirect right of action', not through the debtor to pay, but through a third party, so is not good to be called 'direct'. With regard to its jurisprudence, it has been pointed out that the "direct compensation rules" may be based on a system of 'authorization for the collection of claims' in a system of rules of the law of debt in order to achieve the objective of creditors exercising the claims of others in their own name and retaining the benefits of the corresponding claims. 'Authorization for the collection of claims' is an authorization by which another person is granted the right to collect a claim and to bring the corresponding action, without changing the subject of the right

to the claim (the creditor). The right to collect claims consists of the two core elements of the right to demand and receive performance and the corresponding ancillary rights, and Article 537(1) of the Chinese Civil Code is the legal authorization for the collection of claims. As for the term "direct", the right of subrogation in the Chinese Civil Code is in fact similar to the direct action in the French Civil Code, in that the creditor can sue the debtor's counterparty directly, which also puts the creditor in a much better position than in the indirect action. From the perspective of comparative law, the subrogation system of various countries no longer follows the traditional "rules of warehousing", and the effect of exercising subrogation rights is almost no different from the application of the "direct compensation rules". It can be said that the provisions of Article 537(1) of the Chinese Civil Code reflect the "direct compensation rules", which follows and leads the trend of comparative law. At the same time, due to the Chinese judicial practice has been adhering to the "direct compensation rules" approach, if the Chinese Civil Code, Article 537, paragraph 1, with "rules of warehousing" and its derivatives of the relevant theory interpretation, there will be a disconnection between theory and practice, and at the same time, will not be able to achieve the legislative effect of theory to guide practice. It is also impossible to achieve the legislative effect of theory guiding practice.

With regard to the provisions of paragraph 2, some scholars believe that it is "restrictive rules of warehousing", i.e., in the event of the debtor's insolvency, the property of the debtor's counterparty should be included in the debtor's liable property and then be distributed among all creditors. The author disagrees. Article 537(2) of the Chinese Civil Code covers not only the situation where the debtor is insolvent, but also the situation where the relevant claims have been subject to measures of preservation and enforcement. In the latter case, the relevant claims are paid directly by the creditor that initiated the preservation or enforcement measures, rather than being distributed among all creditors after being "warehouse", and therefore the rule limiting banked claims does not explain this situation. At the same time, the author is of the opinion that paragraph 2 cannot be regarded as a restrictive provision on the "direct compensation rules", and its intention is not to restrict the "direct compensation rules". Regardless of the provisions of paragraph 2, if the creditor exercises the right of subrogation in the situation that should be regulated by the Law on Bankruptcy of Enterprises and the Law on Civil Procedure, the relevant provisions shall be applied. Therefore, the second paragraph of Article 537 of the Chinese Civil Code actually serves as a reminder and notice.

In conclusion, after rejecting the reasonableness of the interpretation methods of "rules of warehousing combined with set-off rules", "priority compensation" and "restrictive rules of warehousing", the author believes that with regard to Article 537 of the Chinese Civil Code, paragraph 1 should be interpreted as the "direct compensation rules" and paragraph 2 as a cautionary provision. The "direct compensation rules" is not only more in line with the relevant expressions of Chinese legislation, at the same time, since the development trend of comparative law on this issue is from "rules of warehousing" to "direct compensation rules", the interpretation method of the "direct compensation rules" is more in line with the trend of comparative law development and does not open the backward carriage of history. In addition, as China's legislative practice has always adhered to the "direct compensation rules", this way of interpretation can also promote the unity of theory and practice, and better play the legislative effect of theory guiding practice.

6. Conclusion

Since the original Contract Law of China first provided for creditor subrogation rights, the legal effect of the exercise of creditor subrogation rights has been centred on the doctrinal controversy between "rules of warehousing" and "direct compensation rules". In order to clarify the corresponding legal effect and provide a clear interpretation of Article 537 of the

Chinese Civil Code, this article traces the emergence and development of the right of subrogation from the perspective of comparative law, and finds that from the French Civil Code to the Japanese Civil Code, the trend of development from the traditional "rules of warehousing" to the "direct compensation rules" is reflected in the development of the legal provisions to the development of jurisprudence and doctrine. At the same time, the author refers to Chinese jurisprudence and finds that Chinese judicial practice upholds the "direct compensation rules", which is also consistent with the official interpretation of the legislation, which aims to mobilize creditors to enforce their claims and strengthen the protection of the enforcement of claims. On the interpretation of Article 537 of the Chinese Civil Code, this article proposes that the corresponding contents of paragraphs 1 and 2 should be interpreted by the "direct compensation rules" and the note provisions respectively. The interpretation method of "rules of warehousing combined with set-off rules" originated in Japan, due to the higher conditions of the set-off rules, and there is no "intermediate omission of registration" violation of the real state of change of property rights in China, the interpretation method does not fit into China's legislation and practice. Since the creditor does not have a right of priority in the exercise of subrogation, it is not appropriate to use the term "priority compensation". With regard to the "restrictive rules of warehousing", the author considers that it does not fully encapsulate the legislative provisions of paragraph 2. This paper puts forward the "direct compensation rules + the note provisions" method of interpretation, in the debt law rules system, which can be found in the authorization of the collection of claims of the theoretical basis, at the same time is also closer to the "Chinese Civil Code" of the legislative expression, in line with the trend of the development of comparative law, consistent with the judicial practice in China.

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