# CHAPTER 1

# BACKGROUND AND INTRODUCTION

## 1. INTRODUCTION AND BACKGROUND TO SECURITY TRANSACTIONS

### 1.1 Law merchant

**[1-1]** The principles regulating the law of security are derived from several sources including the law merchant, contract, property concepts, equitable concepts, and remedies at common law and in equity.

**[1-2]** The Law Merchant, or mercantile law, refers to customs of merchants and traders which were common in England and continental Europe, notably from the fourteenth century onwards. Various sources were said to be the foundation of Law Merchant, such as the early 'banking' activities of the Knights Templar.[1]

**[1-3]** Law Merchant law applied to local English merchants and traders, as well as to those from Continental Europe with whom English traders dealt with in English markets and those on the continent. In England and elsewhere, special courts were established to hear complaints about transactions. In England, these courts were independent from the King's Courts. Therefore, courts of fairs, courts of large towns, and of Staple (dealing with staple products, such as wool) were established from the fourteenth century onwards, and they continued to deal with mercantile complaints until at least the sixteenth century (for local merchants) and mid-seventeenth century for foreign merchants. The core of jurisdiction in these courts was the customary law of merchants, their usage as developed through their various activities. Remnants of these customs remain today in the common law courts: for example the effect of a bill of exchange, the role of the bill of lading (as maritime and mercantile law were closely allied in early centuries), and questions of title to personal property.[2]



1 See Ferris E, *The Financial Relations of the Knights Templar to the English Crown* (1902) 1 American Historical Review 1.

2 See generally *Goodwin v Robarts* (1875) LR 10 Ex 337; *Brandao v Barnett* (1846) 12 Cl & Fin 787; and *Hargreaves v Spink* [1892] 1 QB 25.

## 1.2 A rule of law

**[1-4]** When a custom was recognised as binding on the parties before the court, and as being universally accepted and applied by merchants and traders, it became established as a rule of law. A rule of law indicates that a combination of facts results in legal consequences accepted by the court without the need for proof. Thus, historical knowledge of the law, plus precedents relying on judicial interpretation of that law, and finally acceptance by the courts as the law to be applied in a particular fact situation, meant that mercantile law merged into common law as an essential part. *Stare decisis* is a basic principle of common law by which precedents, within a given hierarchy, are authoritative and binding, and so must be followed.[3]

**[1-5]** Mercantile[4] customs were gradually drawn into, and became part of, the law of England for commercial matters; much of this adaption activity took place in the court of Lord Mansfield from 1756 to 1788. This process was achieved largely by the courts taking judicial notice of the relevant principles from mercantile law; and then applying those principles to the common law claim before the court. Acceptance of these principles then led to the nineteenth century codification of commercial law such as the Bills of Exchange Act 1882 and the Sale of Goods Act 1893.[5]

## 1.3 Law merchant as part of common law

**[1-6]** As the principles of Law Merchant progressively became part of the common law, in relation to commercial or mercantile affairs, by the nineteenth century the courts observed these principles, rather than pure common law principles.[6] Once universal customs of mercantile law had become part of the common law, it was no longer necessary to prove the incidents of custom in each case. Instead, the court could take judicial notice of the relevant practice thereby adopting it as part of English common law. The result was that a particular mercantile custom either had no independent force outside the express terms of the contract, or it was considered to be part of common law.[7] In the latter situation,

3 See *China Field Ltd v Appeal Tribunal (Buildings)* [2009] 5 HKLRD 662, [2009] 5 HKC 231 (CFA).

4 *Carter v Boehm* (1766) 3 Burr 1905. See also the earlier decision of Holt JC in *Lethulier's Case* (1692) 2 Salk 443 where it was said that 'We take notice of the laws of merchants that are general, not of those that are of particular usage'.

5 See *Brandao v Barnett* (1843–60) All ER Rep 719 (HL); *Newcastle Fire Insurance Co v Macmorran & Co* (1814–23) All ER Rep 467 (HL). Many of the codifications were followed in Hong Kong. See for example: Bills of Exchange Ordinance (Cap 19); Bills of Sale Ordinance (Cap 20); Law Amendment and Reform (Consolidation) Ordinance (Cap 23) ['LARCO']; Partnership Ordinance (Cap 38); and Sale of Goods Ordinance (Cap 26).

6 See *Goodwin v Robarts* (1875) LR 10 Ex Ch 337; cf *Crouch v Credit Foncier of England* (1873) LR 8 QB 374 which was reversed in part by *Goodwin*.

7 *Meyer v Dresser* (1864) 16 CBNS 646.





it was unnecessary to plead or prove it specifically.[8] In *Vanheath v Turner*[9] it was said that 'the Law Merchant was part of the Common Law of the Kingdom, of which the judges ought to take notice'. However, as the usages of a particular trade were not considered part of Law Merchant because they were not universal in application, they would not apply unless they could be proven specifically in any given case.[10]

## 1.4 Significant commercial developments in the nineteenth century

### 1.4.1 Legislation and Law Merchant

**[1-7]** There were significant developments in the nineteenth century in a variety of matters which have had a large impact on what we now call 'secured transactions', and the development of the modern 'quasi-security transactions'. This may well have been because it was in that century that many principles of Law Merchant, or mercantile law, were codified into legislation. The courts moved on from the adoption of many of the principles of mercantile law where apt, as 'rules of law' and in the nineteenth century, Parliament adopted many of those principles as the common law of England, thereby making the underlying principles available for all persons dealing with the common law by means of codifying enactments.

**[1-8]** Certain mercantile principles were codified during the nineteenth century, including those relating to negotiable instruments and similar documents by the Bills of Exchange Act 1882 (see the Bills of Exchange Ordinance No 3 of 1885), and for the sale of goods by the Sale of Goods Act 1893 (see the Sale of Goods Ordinance No 4 of 1896). Of course, many of these principles were from Law Merchant. Apart from codification, a large amount of specific legislation was enacted to deal with commercial transactions and principles. Much of the impetus for nineteenth century codification had come from merchants' associations such as the Association of Chambers of Commerce who paid for the preparation of the Partnership Act 1890 (see the Partnership Ordinance No 1 of 1897). Some nineteenth century legislation merely amended pre-existing statutes (for example, Bills of Sale Acts: see for Hong Kong the Bills of Sale Ordinance No 5 of 1856), whilst others were quite innovative (for example, the Bills of Exchange Act). Once enacted in England, many of these amendments or new laws were adopted in most colonies; sometimes in the same form but in other cases with variations to reflect a common proviso in most English colonies in Asia. This proviso was that the laws of England, including in some cases the legislation itself, were to be in full force in the Colony, 'except where the same shall be inapplicable to local circumstances of the colony or its inhabitants'.[11]

8 *Woodward v Rowe* (1666) 2 Keb 105.

9 *Vanheath v Turner* (1621) Win 24. See also *Produce Brokers Co Ltd v Olympia Oil and Coke Co Ltd* [1914–1915] All ER Rep 133 (HL).

10 *Lloyds Bank Ltd v Swiss Bankverein* (1913) 108 LT 143 (CA, Eng).

11 Section 3 of the Supreme Court Ordinance (Cap 4), enacted as No 15 of 1844; on UK legislation adopted in Hong Kong.

### 1.4.2 The development of commercial law

**[1-9]** In the nineteenth century, England required of its merchants profits from around the world to stabilise the country and to make use of the products of the industrial revolution. To enable this, Parliament and the courts were prepared to allow a 'laissez faire' approach to legal regulation. So, whilst towards the end of the nineteenth century, codification of what had been law merchant principles took place to meet the requirements of commercial law, micro-regulation was absent. The commercial transactions, and in particular those relating to borrowing of money by merchants and thus the development of the banks over the nineteenth century, set out the basic pattern of commercial law up until today. Three features stand out in this regard.

**[1-10]** *First*, the conversion of mercantile law (previously applicable only to merchants and traders) as part of the general, common law was made available in commercial transasctions generally. Legislation reflected the Law Merchant, as well as other relevant commercial matters including developments in modern commerce, and sometimes with a large overlay from equity. Much of the nineteenth century legislation remains enforceable in its original form in Hong Kong;

**[1-11]** *Second*, the role of equity was essential in enabling the effective introduction of various transactions, as well as in the revival of traditional forms of assistance, and protection. Protection was devised primarily for the party who in modern terminology is called the 'consumer'; see for example principles relating to clogs on the equity of redemption; relief against forfeiture of interests such as that under a lease; and the examination and classification of agreed sum clauses. But for equity's intervention in recognising future or after-acquired property, the floating charge would not have been possible, with the result that companies would not have been able to continue to trade whilst 'securing' their trading stock to the lender.

**[1-12]** These developments were made necessary, and hastened, by the progressive alteration of the nature, effect and prominence of a company, from its beginnings particularly from the sixteenth century in the form of a chartered company (to carry out monopolistic rights, such as those granted to the East India Company) through the seventeenth and eighteen centuries with the joint stock company (which functioned as partnerships), and continuing through to the nineteenth century company, which is more akin to the form it has today.[12]

**[1-13]** The development of company law brought about the introduction of various trading companies that were entitled to issue 'shares' in the financial activities of the company, the so-called joint stock company, in which the Government (or the Crown itself) was a subscriber. These 'companies' functioned originally as partnerships with each 'corporate' activity being an individual profit-making venture; the capital of the company was not permanent as each owner could remove his capital after each venture. By the mid-seventeenth century, the demand for longer term capital, both equity capital as well as debt capital (from borrowings

12 On this see the early legislation such as the Joint Stock Companies Act 1844, the Companies Clauses Act 1845, and Limited Liability Act 1855, and the Joint Stock Companies Act 1856, and the Companies Act 1862.





with re-payment of money on termination or default), became common. The result was the introduction of a secondary market for trading debt and equity instruments. Then the limited liability company developed as a discrete legal entity. This resulted in capital being owned by a fictional legal person who was required to undertake commercial actions on its own account. Whilst the merchant would have, or could have, mortgaged his assets, this meant that their use was lost to him until redemption as title passed to the mortgagee during the currency of the loan, and thereafter on default until sale. Assets sold or dealt with in the course of the borrower's business could not be mortgaged, and for this reason the floating charge enabled merchants who had mortgaged their lands, or who did not own land, to borrow on the security of the 'company's undertaking'.

**[1-14]** The *third* matter of interest is probably the attempt to protect the owner of goods from the activities of a rogue. Usually this requires the law to decide which of two innocent parties is to suffer in cases where the rogue has passed possession of the owner's goods to a bona fide purchaser for value without notice of the defect in title. Protection of the purchaser represents an exception to the principle of *nemo dat quod non habet*. This principle is that 'no one gives who possesses not' or that 'he who has not title cannot pass title'.[13]

**[1-15]** This principle and several exceptions were entrenched in the Sale of Goods Act, and the Factors Act. Their presence and the manner in which the courts usually weighed the balance against the true owner in any circumstances where the exceptions were present, spurred suppliers to develop various forms of personal or quasi-security, such as hire-purchase to better protect their property right.

**[1-16]** So, during the later years of the nineteenth century, the legislating zeal of Parliament re-examined and amended earlier 'commercial' principles in light of the new legal identity in the person of the company. The company became prominent in transactions of loan and security, and in addition traditional equitable rules were propounded and applied in new ways, and to 'new' forms of transactions. Of course, the basic structures remained in force; often, however, with a new title or form.

### 1.4.3 Other nineteenth century developments

**[1-17]** There were other subsidiary, or complementary, nineteenth century developments including:

(a) the abolition of the prohibition of 'usury', ie the charging of interest, in 1854 followed several decades later by the Money-Lenders Act 1900 made necessary by the excesses of unregulated, rapacious, money lenders after 1854.

13 See *Helby v Matthews* [1895] AC 471 (HL) but cf *Bruton v Quadrant Housing Trust* [1999] 3 All ER 481 (HL) (where a licensee was held able to grant a lease of land for the duration of the licence, despite his absence of possessory rights derived from the holder of the legal title).

It is to be noted that more recent, twentieth century developments of remedial relief in the form of 'restitution', as the prevention of general, unjust enrichment, have resulted in a practical reversal, or perhaps avoidance, of the common law rule that 'a debt does not carry interest unless the parties agreed expressly or by implication that it should'.[14] A case in which iunjust enrichment morphed into 'common law damages' in relation to repayment of overpaid tax, was *Sempra Metals Ltd v IRC & Anor*[15], where the House of Lords said that the court has jurisdiction at common law to award compound interest in respect of a restitutionary remedy for the time value of money paid under a mistake. It may well be that this view can be extended beyond restitutionary relief as a general factor in loan contracts. Indeed the House of Lords said, of compound interest, in *Sempra Metals v IRC* (above), that it is now the accepted form of interest in commercial transactions;

(b) the use of the assignment of the benefit of a chose in action as a form of security for the book debts of the company, assisted by Equity in permitting by the company to grant security over future property, ie, the proceeds of the book debts, prior to those proceeds coming into the hands of the company.[16] This was made possible in the form of the equitable floating charge, in which the trust, equity's main machine of relief, played a role. Any jurisdictional differences between legal and equitable chose had been abolished in England by the Judicature Acts 1873–1875. It is to be noted that in Hong Kong, from its beginning, there was no separation of the Court of Chancery from the common law courts.[17]

(c) the establishment of principles of priority in relation to multiple assignments of the benefit of the chose in action, known as 'the rule in *Dearle v Hall,*'[18] thereby enabling the assignment of the chose in action to function more perceptibly as an element of security; and

(d) the continued presence, of several Chinese customary loan transactions which have been somewhat changed by legislation, such as the chit fund (see the Chit-Fund Businesses (Prohibition) Ordinance (Cap 262) which restricts the operation of certain chit-funds), or the modern regulation of traditional pawnbroking (see the Pawnbrokers Ordinance (Cap 166) for which the customary rate of interest, namely 3.5% per lunar month continues to apply).

### 1.4.4 Nineteenth century developments in contract and property law

**[1-18]** Apart from codification, the nineteenth century was a busy period for legislation relating to commercial transactions, the developing regulation of the

14 *President of India v La Pintada Compania Navigacion SA* [1984] AC 104 (HL).
15 [2007] 4 All ER 657 (HL).
16 *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284 (CA, Eng).
17 See the Supreme Court Ordinance No 15 of 1844, ss 13 and 14.
18 (1828) 3 Russ 1.





company, activity in relation to priorities found in a variety of contract, property or security decisions, and the extension of certain contractual concepts such as resulted in *Carlill v Carbolic Smoke Ball Co.*[19] The great commercial 'invention' of the nineteenth century was, of course, the floating charge enabling companies to borrow on stock in trade, both present and future. The nineteenth century also marked the final adaptation of the law merchant into the common law, especially by the codification of principles, for example the Bills of Exchange Act 1892. International trade ensured that the Bill of Lading retained its traditional attribute as the only common law document of title.

## 1.5 Usury and interest payments

**[1-19]** One factor that enabled the expansion in, and development of, commercial law in the nineteenth century was that of the payment of interest on a loan. The proscription on the charging of interest, which had been first introduced in 1190 as usury, had been finally abolished in 1854 by the Usury Repeal Act to meet growing commercial demands for freedom of contract in lending and finance. Although the proscription had been modified over the centuries thereby allowing a money lender to charge a statutory rate of interest in certain cases, the repeal meant that there were no limits at all on the amount of interest chargeable, and interest was no longer to be considered contrary to the medieval view that it was sinful to make a profit on the loan of money.[20] Consequently without barriers, the rate of interest flowed freely. Exorbitant and unconscionable rates being charged as a norm, and in conjunction with loan contracts containing other unconscionable and oppressive terms. Whilst the Court could reopen a harsh and unconscionable contract, the unregulated rate of interest was an indefinite and unreliable cause of complaint.

**[1-20]** Eventually in 1900, the Money-lenders Act was passed to require moneylenders to be registered, and to impose some restraint on the rate of interest charged. Registration simply required an application to register and the payment of a fee; hence there was no supervision of moneylenders or any inquiry as to the bona fides of the moneylender. The Act provided for insertion of certain information about the lender and the details of the loan in the agreement. But there was no regulation of the conduct of the money lending business. It was not until the Money-lenders Act 1911 that the business of the money lender was regulated by requiring the lender to be licensed by the Board of Trade; however as the Act provided for certain money lenders and certain loans to be exempt from its terms, not all transactions were covered. Licensing required some form of scrutiny of the person applying for the licence. Freedom of contract allowed the parties (or more correctly, the moneylender) to contract as they wished so long as the terms were not illegal.

**[1-21]** Realistically, until 1911 the Court would enforce the promise to pay interest without much scrutiny. So, where a contract expressly provided for the payment of interest, the court could not intervene.[21] A court of equity would allow the payment of interest, despite it not being referred to in the contract, where a mortgagor

19 [1893] 1 QB 256 (CA, Eng).
20 *Chambers v Goldwin* (1804) 9 Ves 254.
21 *Hamlin v Great Northern Railway Co* (1856) 1 H&N 408.

of the debtor by way of charge or mortgage. This binding of a third party's assets is referred to as a collateral transaction which extends the manner in which the creditor can seek repayment or satisfaction; and

(c) where there is an instrument which creates, or acknowledges, an obligation to repay a sum of money, or to perform an obligation. Without more, the document (for example, a Debenture) might not create any security. To achieve a collateral security to the contractual obligations, the document must contain terms to achieve this purpose; if it fails to do so, the law will require the execution of the additional documentation and perhaps registration of that documentation to perfect any interest sought to be created in respect of the asset. Where the initial documentation refers only to the debt, then it merely creates, and evidences, a contract which gives no immediate or direct recourse to the assets of the 'borrower' as security for the repayment of the loan or performance of obligations.[26]

A 'secured' interest gives the creditor a proprietary interest in the secured asset, enabling some form of 'seizure and sale' on default.

**[1-30]** In *Singer v Williams* [1921] 1 AC 41, it was said, at 49–50, that:

> The normal meaning of the word 'securities' is not open to doubt. The word denotes a debt or claim the payment of which is in some way secured. The security would generally consist of a right to resort to some fund or property for payment; but I am not prepared to say that other forms of security (such as a personal guarantee) are excluded. In each case, however, where the word is used in its normal sense, some form of secured liability is postulated. No doubt the meaning of the word may be enlarged by an interpretation clause contained in a statute, as by the interpretation clauses in the *Conveyancing and Law of Property Act* 1881, the *Settled Land Act* 1882, the Trustee Act 1893, and the Finance Act 1916; or the context may show, as in certain cases relating to the construction of wills, *Re Rayner* ([1904] 1 Ch 176; 89 LT 681) and *Re Gent and Eason's Contract* ([1905] 1 Ch 386; 92 LT 356) that the word is used to denote, in addition to securities in the ordinary sense, other investments such as stocks or shares. But, in the absence of any such aid to interpretation, I think it clear that the word 'securities' must be construed in the sense above defined, and accordingly does not include shares or stock in a company.

So, the word here will be used with this in mind, defining it where necessary.

## 1.10 Contractual relief

**[1-31]** Where there is no secured interest, the remedy of the creditor will rest usually only in contract. In contract, the case of a contract, the remedy can be:

(a) a judgment debt requiring thereby court proceedings;
(b) perhaps action for the 'contract price' again requiring court proceedings;
(c) action for breach of contract; again requiring court proceedings.

26 See *Independent Television Authority etc v IRC* [1961] AC 427 (HL); *Knightsbridge Estates Trust v Byrne & Co* [1940] AC 613 (HL); and *Edmonds v Blaina Furnaces Co* (1887) 36 Ch D 215.





**[1-32]** In the case of (a) and (b), the amount sought is a liquidated sum. For (c), the amount sought is unliquidated requiring the plaintiff to show loss from the breach assessed on the basis of *Hadley v Baxendale* (1854) 23 LJ Ex 179, 9 Exch 341; and see recent developments: *Jackson & Anor v Royal Bank of Scotland plc* [2005] 2 All ER 71 (HL); and *De Monsa Investments Ltd v Richly Bright International Ltd* (2015) 18 HKCFAR 232, [2015] 3 HKC 583 (CFA); and *Paul Chen & Anor v Lord Energy Ltd* [2002] 1 HKLRD 495, [2002] HKCU 236 (CFA).

In all three cases, failure to honour the judgment will result in action for execution (see for example Orders 46 to 50 of the RHC) thereby expending time and money without a guarantee of full recovery.

**[1-33]** There is another group of transactions referred to throughout.

These are generally known as quasi-securities; some of which are also termed 'reverse securities' others as 'purchase money securities': still others as 'commercial securities', and a further group as 'taking credit risk on a third party'. By and large these transactions seek to simulate the effect (but not the form) of a 'real', secured transaction, for example, a charge, mortgage, pledge or common law lien, despite the absence of necessary formalities with the result that the substance of the particular transaction is purely contractual. In so doing, the creditor expects that the form of his contract will maintain, sustain, and actively protect his interest, and right of recovery, despite the competing rights of secured creditors, prior interests and such.

# CHAPTER 2

# PROPERTY

## PART A

## BACKGROUND

## 1. INTRODUCTION

### 1.1 Personal property

**[2-1]** Personal property is divided into three types. These are (1) chose (or choses) in action, (2) chose (or choses) in possession, and (3) land as chattels real.[1]

**[2-2]** A *chose in action* is a right that can be enforced and enjoyed by taking action. It has no physical attributes, making it 'intangible and immovable'. There are two forms of a chose in action, namely (a) the benefit which reflects the right of the holder to take action to enforce the right, and (b) the burden, that is the obligation to perform which on default makes the obligor/covenantor the defendant when sued by the obligee/covenantee.

**[2-3]** By contrast to the chose in action, the *chose in possession* does have physical characteristics. It is movable, tangible, capable of physical possession: *Joseph v Phillips* [1934] AC 348 (PC). As such, a variety of forms of security are available for choses in possession. Examples of choses in possession include goods, heavy machinery, vehicles, and stock-in-trade.

**[2-4]** The third division of property is that of land. Due to historical reasons, as there is no freehold available to land-owners in Hong Kong,[2] land is classified as *chattels real*. Land is alienated in Hong Kong by way of leasehold, although in legislation and in common parlance the Government lessee is referred to as the 'owner'.

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1 Historically under English law, land held by way of leasehold was treated as personal property, hence the term 'chattels real'. Although for the purposes of relief on the dispossession of the lessee of leasehold land, this distinction between leasehold and freehold in this regard was removed, yet the classification of leasehold land remained. The general definition of 'chattels real' is that they are extracted out of real estate.

2 Only the land on which St John's Cathedral is situated is held on freehold title: see s 6 of the Church of England Trust Ordinance (Cap 1014).

## 1.2 The basic elements of personal property

**[2-5]** An item of personal property can be classified as legal or equitable. This classification refers generally to the type of relief available to the owner, or where the asset has been used as security for a loan, by the lender. In some cases, as with an equitable charge over the benefit of a chose in action, the classification restricts the type of security available.

**[2-6]** The second form of classification of personal property relates to the manner in which it was created. Where a contractual obligation is created in relation to the asset, the contract gives rise only to contractual rights on default, namely either to common law damages or if appropriate to an action for debt. However, if the obligation is proprietary, then the remedy available on default is resort to the asset itself; where the contract establishing the proprietary interest, or legislation, permits sale, there is no need to approach the court as the means of satisfaction of the obligation rests in the disposal of the asset by the obligee.

**[2-7]** All three types of personal property may be classified as legal or equitable. There is also a group of property rights for which a court may be prepared to grant relief inconsistent with the personality of that property. For example, in *Latec Investments v Hotel Terrigal* (1965) 113 CLR 265, BC6500350, in *De Mattos v Gibson* (1858) 45 ER 108, and in *Dynex Petroleum Ltd v Bank of Montreal* [2002] 1 SCR 136 (SCC).

## 1.3 The differences between the three types of property

**[2-8]** The main differences between the three types of property relate to their attributes, and in particular their relationship to whether or not the property is tangible or intangible, movable or immovable.

**[2-9]** A chose in action, as either the benefit or the burden, is an intangible and immovable item of property. It is merely a right to sue in court to exercise and obtain the right represented by the chose. Generally, this will be in an action for debt where the court will order the debtor to make good his promise to pay. This is not a proprietary claim but one based in contract.

**[2-10]** A chose in possession is a tangible and movable asset. It covers a wide variety of items of personal property. The owner has a proprietary right to recover the asset when it is dealt with adversely by a third party.

**[2-11]** Land is immovable but most transactions with land will give rise to a proprietary interest.

**[2-12]** The attributes of the items of property determine the manner in which the asset may be dealt with. For example, an intangible asset cannot be the subject of a possessory security; nor can land. All assets may be the subject of mortgages or charges, some of which can be legal (for land: s 44(1) Conveyancing and Property Ordinance (Cap 219)) whereas a chose in action may only be the subject of an equitable charge.





## 1.4 Traditional description of types of property

**[2-13]** An item of personal property classified as intangible is also referred to as an 'incorporeal interest'.[3] Thus a chose in action also can be referred to as such. Other examples are interests in land, such as easements. Other interests are referred to as 'corporeal interests'. Traditionally, the term 'hereditaments', not interests, was used with corporeal or incorporeal indicating that the item of property could (corporeal) or could not (incorporeal) pass to the heirs of the holder of the interest on his death. The item was treated as being permanent and tangible.

**[2-14]** The definition of incorporeal hereditaments was adopted by Cotton LJ in *Re Christmas* (1886) 33 Ch D 332 (CA) to the effect that it is:

> … a right issuing out of a thing corporate [i.e. tangible], whether real or personal, or concerning, or annexed to, or exercisable within, the same. It is not thing corporate itself, which may consist in lands, house, jewels, or the like; but something collateral thereto, as a rent issuing out of those lands or houses.

**[2-15]** Originally, the focus on corporeal and incorporeal hereditaments was on questions of succession. Land and fixtures represent corporeal hereditaments. The language and the concept of hereditaments remain, but they have lost much of their relevance in modern law.

## 1.5 Ownership of property

### 1.5.1 Common law

**[2-16]** In general, the interest which the owner of property has is a combination of the title and possession, that is *dominium*. The dominium may be legal or equitable.[4] This principle applies to choses in possession and to land. However, when considering choses in action it is clear that there is no 'possession' of the asset because it is intangible.

**[2-17]** At common law, dominium was merged in the ownership of an asset, allowing him to deal separately with possession from the title. This facility applied to both chose in possession as well as to land; however only ownership is enjoyed over a chose in action.

**[2-18]** Whilst the term 'title' is inter-changeable with 'ownership', when considering assets other than land, the term 'property'" is commonly used. Whatever term is used, dominium gave absolute rights over property. The rights combined title and possession.

**[2-19]** Common law treated ownership as giving rise to certain consequences including:

3 *Torkington v Magee* [1902] 2 KB 427; and see *Colonial Bank v Whinney* (1886) 11 App Cas 426, [1886–90] All ER Rep 466 (HL).

4 Until fusion of the Courts by the Supreme Court of Judicature Acts 1873 to 1875, there were two court systems in England; one was the common law system and the other was the Court of Chancery administering equitable principles. Hong Kong never had this division of the two systems: see the Supreme Court Ordinance No 15 of 1844.

(a) the absolute right of ownership, including the right to dispose of the property, supported by the principle of *nemo dat quod non habet* to the effect that a person without title cannot pass title in the property. Various exceptions developed to *nemo dat*, but the principle remains sound as indicating the absolute right of the owner. Exceptions include ss 23 to 27 of the Sale of Goods Ordinance (Cap 26), and the terms of the Factors Ordinance (Cap 48); and see *Newtons of Wembly Ltd v Williams* [1965] 1 QB 560;

(b) The person with the right to possession, or the immediate right to possession, was the only person entitled to take action for its recovery of the asset; for example when it had been taken unlawfully. There was no corresponding remedy in respect of a chose in action because that item of property is enforceable only by taking action in court;

(c) Generally, title without possession was not treated as a right *in rem*, until, by some form of *novus actus*, the title was vested in the person with possession.

Common law could not recognise a dealing with future, or 'potential', property until the property had become 'present' by coming into the hands of the 'seller'; then a new contract would be required to deal with the property, or the seller had to deliver the goods to the buyer, or appropriate them to the buyer: see s 7 of the Sale of Goods Ordinance allowing the transaction to create 'an agreement to sell'.[5] So the purported assignment of a 'thing' before it exists has no effect at common law other than as a contract to assign: thus

> The earliest moment at which the property in the thing can actually pass is when it first becomes extant.[6]

(d) To protect the true owner, various enactments operated to prevent fraud and improper dealings.

### 1.5.2 In equity

**[2-20]** Equity thought differently from the common law in relation to property and property rights. Equity could recognise that a right to a future chose in action or a future chose in possession could be disposed of by the owner. This meant that equity concentrated on the contract to dispose of that future property. As equity would not assist a volunteer, in this context, the contract had to evidence consideration; for equity, a deed would be inadequate for this.[7] Thus the conscience of the 'owner' of the future property was bound by equity in 'looking on that as done that which ought to be done'.

5 See *Lunn v Thornton* (1845) 1 CB 379, 135 ER 587, and s 7(3).

6 *Norman v Commissioner of Taxation* (1963) 109 CLR 9, per Windeyer J at 25, a decision of the High Court of Australia.

7 See decisions such as *Re Goldcorp Exchange Ltd* [1995] 1 AC 74 (PC); and see *Holroyd v Marshall* (1862) 10 HL Cas 191; *In Re Lind* [1915] 2 Ch 345 (CA, Eng).





## 1.6 Proprietary rights: Common law and equity

**[2-21]** Basic property principles evolved over the centuries in common law, to result in proprietary rights which:

(a) enabled the owner to exclude strangers from access to his property;
(b) allowed him to assign it to third parties, or deal with it by trust or gift; and
(c) allowed him to transfer its commercial value.

**[2-22]** Equity recognised rights as proprietary and others as personal. This division started, at least, in the thirteenth century with the 'use', the early form of a trust. Under this, two or more persons could hold the bundle of rights in an asset, amounting to *dominium*, by one part being held by a trustee thereby holding the legal or proprietary estate, and the other held by a beneficiary thereby holding the equitable or beneficial estate. The beneficiary's personal rights were protected in equity by action against the trustee, but not as giving any right against third parties. Eventually equity treated these personal rights as proprietary. By the nineteenth century the original personal right had become assignable to a third party and enforceable by him.

**[2-23]** In equity, the proprietary rights were:

(a) specifically enforceable;
(b) assignable to third parties; and
(c) enforceable by and against third parties.

A proprietary interest is enforceable against third parties.

## 1.7 Invasion of proprietary rights

**[2-24]** As a result of recognition of proprietary rights by both common law (albeit only its own principles and concepts) and equity (both its own principles and those of the common law), the invasion of a proprietary right could give rise to a claim for compensation against the invader – even in cases where no financial loss was suffered thereby.

**[2-25]** The origins for this relief were in the writ of trespass – an unlawful interference with the possession of the person entitled thereto. This applied to land (trespass) and to goods (now referred to as conversion or detinue) but not to a chose in action (over which it was impossible to have possession). Relief was based on the principle of unlawful 'user' of the property of another:

> (a) Wherever an abstraction or invasion of property has occurred, then, unless such abstraction or invasion were to be sanctioned by the law, the law ought to yield a recompense under the category or principle either of the price or of the hire.[8]

8 *Watson, Laidlaw & Co Ltd v Pott, Cassels & Williamson* [1914] 31 RPC 104 (HL), 119 per Lord Shaw.

## 1.8 Chose in action evidenced by a document

**[2-26]** The strict division between chose in possession and chose in action in relation to possession has not been maintained absolutely. Although, the old law was that conversion and detinue were actionable only in respect of goods and chattels, because:

> A man cannot have a proprietary interest in a debt or other obligation which he owes another.[9]

**[2-27]** Yet in some cases where the chose in action is represented by a piece of paper, evidencing the terms of the chose, then recovery of compensation, representing the face value shown on the paper, may be obtained. These cases can be:

(a) by reference to the terms of a contract (not always successful);
(b) by reference to statute (such as the Factors Ordinance (Cap 48)); and
(c) law merchant, a fertile area for alteration of basic common law principles; examples are negotiable instruments and bills of lading.

**[2-28]** One example of concern, but also one pronounced by several superior courts to be of no concern or dispute, is that of a share certificate that is evidence of the interest of a shareholder in a company. The certificate obviously has a physical form. Mercantile custom and practices, later supported by legislation, were adopted in respect of permitting an action for unlawful interference with the document by an action in conversion. But this indulgence was never given to the share certificate, a document that developed during the nineteenth century in the form it is today. As such it was not a document that had been universally accepted by merchants as part of the customary documentation to be protected by law.

**[2-29]** The other benefit denied a share certificate is that it cannot be used for a possessory security, such as a pledge: generally, see *Silver Stone Development Ltd & Anor v Liu Kwong Ching James & Ors* [2007] 2 HKLRD 717, [2007] 4 HKC 77 (CA) (the share certificate is not able to be pledged or converted), and comments against expansion of conversion generally in *OBG Ltd & Ors v Hello! Ltd & Ors* [2007] 2 WLR 920 (HL); by contrast see the Bills of Exchange Ordinance (Cap 19) which gives effect to mercantile customs in relation to negotiable instruments.

## 1.9 The role of equity in property law

**[2-30]** In the nineteenth century, equity intervened in commercial law to assist in the expansion of security over company assets. Company law had undergone major changes since the eighteenth century when a company was a partnership; this continued up to mid-nineteenth century when the company became the institution we have today. Companies needed the availability of finance, and lenders required adequate protection for recovery of money lent. Where a company had mortgaged its land, and had only stock-in-trade to offer as security, common law permitted only present property to be used for this purpose. Equity offered its remedies in relation to future or after-acquired property, enabling a company to use book debts (promises from debtors to the company to repay a debt on a due date) or stock to be acquired in the future as the subject matter of the security. Equity imposed a trust on the borrower not to deal with the future property against the interests of

9 See *Re BCCI SA (No 8)* [1998] AC 214 (HL), at 226.





the first-in-time lender. Thus, the equitable charge, especially in the form of the floating charge, was developed in equity. The trust therefore, in a variety of forms, became the tool for the expansion of successful security in favour of the lender.

**[2-31]** Equity applied other principles to assist where an equitable interest was created. These included:

(a) the remedy of specific performance; common law could award only damages (and these were subject to principles of remoteness and to mitigation) whereas equity could require the defendant to keep his promise; and
(b) the operation of the maxim that 'equity looks on that as done that which ought to be done'. Equity regarded the consequences of an act, required to be performed in accordance with a legal agreement or decision of a trust, as immediate; thus the act accomplished *from the beginning of the transaction* the desired result; for example the doctrine of conversion which brings into being the 'bare' trust on the entry into a valid, enforceable contract for the sale of land.[10] Equity here was acting on the conscience of the defendant who had obtained a benefit from the performance of the plaintiff so that it would be unjust enrichment to keep the benefit without compensation for the plaintiff.[11]

It was this second principle that made possible the role of equity in the nineteenth century invention of the floating charge because it allowed the charge to be created over after-acquired or future property. This was something common law could not (or would not) permit. So:

> [w]hen the property has come into existence, Equity, treating that as done which ought to have been done, fastens on that property and the contract to assign thus becomes an accomplished assignment.
>
> A contract for value for an equitable charge is as good an equitable charge as can be.[12]

**[2-32]** This relief had at least one proviso: equity will not assist a volunteer, and if the plaintiff had not given consideration there was no equitable relief available. Further, equity operated on discretion: it produced a series of discretionary bars to the grant of its relief, such as applies when the plaintiff is found to have acted unconscionably, and thereby perhaps causing the defendant to breach the contract; this is an example of the discretionary bar to the effect that 'he who comes to equity must come with clean hands'.

**[2-33]** In *Re Lind* [1915] 2 Ch 345 it was said that:

> I think it is correct to say that an assignment of a definite property to be afterwards acquired creates not merely a personal liability to transfer the property

10 *Shaw v Foster* (1872) LR 5 HL 321; *Egmont (Earl) v Smith* (1877) 6 Ch D 469; *Lysaght v Edwards* (1876) 2 Ch D 499 (in the context of an agreement to create a lease).
11 This later became relief through restitution or equitable compensation.
12 *Collyer v Isaacs* (1881) 19 Ch D 342 (CA) per Jessel MR; and see *Metcalfe v The Archbishop of York* (1836) 6 LJ Ch (NS) 65; and note *Anisminic Ltd v Foreign Compensation Commission & Anor* [1969] 2 AC 147.

> when the time comes but an actual interest in the assignee as if the assignor had been possessed of the property at the date of the assignment (whether by the application of the doctrines relating to specific performance or of the maxim that 'equity looks on that as done that which ought to be done' it matters not)... the remedy of the assignee is not merely a personal right in damages against the assignor, but a right *in rem* against the subject of the assignment.

Equity enforced this obligation even though at the time it was entered into the subject property did not exist. The inability of the common law to deal with future property meant that it lost it supremacy in property and security matters.

## 1.10 Examples of equitable relief

**[2-34]** The decision in *De Mattos v Gibson* (1858) 45 ER 108 is a nineteeneth century example of how equity could grant some relief in circumstances in which common law would have ignored the claim of a charterer. *De Mattos* concerned a charterparty of a ship where the lessor then mortgaged the ship. The mortgagee, on default, wanted to sell the ship but the charterer was able to obtain an injunction to prevent the sale on the basis that although the charterer had a mere personal right, that right was *treated as being* specifically performable and the court would grant the injunction to protect such a right. The mortgagee's right was proprietary but unable to withstand the interim remedy. The decision went no further than that. The core of the remedy related to the fact that the interest was one that equity itself would protect, subject always to discretionary bars. *De Mattos*, with one or two exceptions, has been followed since, but still giving no more than the interim protective order.[13]

**[2-35]** The judgment had the effect of *seemingly* elevating the personal right in the ship, that is, it was *in personam* not *in rem* as it was merely contractual, that is a chose in action. The remedy was fleeting as the ship then sank because of structural problems.

**[2-36]** A similar approach sometimes is afforded a personal interest by a court prepared to allow the interest to enter into a contest with a bona fide purchaser for value who took with notice of the prior, personal interest. The rule would also apply where the purchaser had 'willful blindness' or 'blind-eye' knowledge. The personal interest, treated as a 'mere equity' is generally unable to be registered under the Land Registration Ordinance (Cap 128) ('LRO') even if it is in writing. However, in *Cheung Wah Nin & Ors v The Land Registry & Anor* [2016] 5 HKLRD 356, [2016] HKCU 2414, the Court granted a declaration that a document entitled a 'Licence' but which granted exclusive right to the subject property was registrable under the LRO.

Similarly in the High Court of Australia, in *Latec Investments Ltd v Hotel Terrigal Pty Ltd* (1965) 113 CLR 265, BC6500350, an equity to set aside for fraud, would have taken priority to a bona fide purchaser for value with notice, had the equity holder done something to protect his interest before the bona fide purchaser came along. This leaves the mere equity enforceable only as a chose in action, if at all.

13 See *Swiss Bank Corp v Lloyds Bank Ltd* [1979] Ch 548, [1979] 2 All ER 853 (HL); *UTG Investments v Petra Bank* [1995] 2 HKC 157 (CA).





In a later decision, *Breskvar v Wall* (1971) 126 CLR 376, the same court elevated the mere equity into an equitable interest.

**[2-37]** The ability of equity to protect a right is one of the characteristics of a right *in rem*: *Brown v Heffer* (1967) 116 CLR 344 where the High Court of Australia added that the interest is 'commensurate only with the what would be decreed to him by a Court of Equity in specifically performing the contract'. In other words, this is commensurate only with the purchaser's ability to obtain specific performance.

**[2-38]** Must the right that is sought to be protected be susceptible to specific performance, or was the generosity of the court based on the operation of the maxim that 'equity looks on that as done that which ought to be done', or did equity act on 'pure equitable principles' preventing unconscionability and equitable fraud because a person dealing with the asset had notice of the prior interest thereby making the subsequent party liable as a constructive trust because of notice?[14]

**[2-39]** The result has been a more intrusive equity into all areas of commercial law, where previously equity's role would have been at best minimal.

# PART B

# THE CHOSE IN ACTION

## 2. The Chose in Action

## 2.1 Emergence of the chose in action

**[2-40]** It was during the nineteenth century in particular that the chose in action (and then especially the book debt) became prominent. This was (a) because for remedial purposes no difference existed between legal and equitable choses in action, and (b) the courts were prepared to apply a large amount of equitable trust law to the commercial use of the chose in action, especially in the form of future or after-acquired property.

**[2-41]** In property terms, there is no possibility of physical possession of an incorporeal chose so that a chose in action may not be used as a collateral, possessory security: *Colonial Bank v Whinney* (1886) 11 App Cas 426, [1886–90] All ER Rep 466, where it was said in the House of Lords in considering s 44 of the Bankruptcy Act 1883, that:

> The question ... is correctly said to be whether the expression 'things in action' as used in this enactment, is intended to include shares in a railway company, which clearly are personal chattels, the property in which does not pass by mere delivery, but does pass by a deed of transfer duly stamped when delivered to the secretary and by him entered in the registry...
>
> There always was a difference between personal property such as to be capable of being stolen, taken, carried away, and so as to be the subject of larceny at

14 See for example *Tulk v Moxhay* [1843-60] All ER Rep 9; (1848) 41 ER 1143.

> common law, and to be capable of being seized by the sheriff under a fi fa, and other kinds of personal property … And when new kinds of property, like stock in the Funds, or, in more modern times, shares in the companies, were created, questions arose whether they were within the principle of being in possession or not; but till the phrase was used in the Act of 1869 , it never became important to inquire whether they were to be called things in action or not. …
>
> …in modern times, lawyers have accurately, or inaccurately, used the phrase 'choses in action' as including all personal chattels that are not in possession.

By contrast, a chose in possession is a tangible item of person property over which one can have not only ownership (as can be held over a chose in action) but also possession due to the physical nature of the property.

**[2-42]** A common chose in action is the benefit of a book debt. This is entry in the books of a company evidencing debts owed to the company. It is expected that payment of the debt will be made on or before the due date. Prior to payment, the book debt is a chose in action representing present property, that is the right to sue if the debt is not paid by the due date. The money due, the physical state of the chose, is future property or after-acquired property. It was the great development of this future property in the later part of the nineteenth century which resulted in the equitable charge. This charge was granted over future property, allowing the debtor to continue to deal with his assets in the usual course of his business.[15] Without equity, this charge would not have been developed. Equity imposes a trust on the debtor to treat the proceeds of the book debts as belonging to the lender.[16]

**[2-43]** The dexterity of the chose in action makes it a common subject of a bank loan to a company. A chose in action can be classified as legal or equitable. A chose in action can be legal or equitable, the classification being dependent on which court would have heard an action for breach prior to the Supreme Court of Judicature Acts 1873 to 1875. The distinction between legal and equitable choses was important in relation to the remedy on default. As fusion of common law and equity courts was achieved by those Acts, the distinction thereafter became irrelevant. Hong Kong never did have the distinction in the two systems, as the Supreme Court has always had jurisdiction in common law and equity.[17]

## 2.2 The chose in action as a contract

**[2-44]** A chose in action is (a) an enforceable contract between debtor and creditor (or other appropriate identities), and (b) it is an item of property able to be used as collateral for a security to repay a debt, or support an obligation.

**[2-45]** The main common law remedy for breach of a contract is damages. However, an award can be inadequate as the plaintiff must prove (a) remoteness and (b) mitigation. By far the better remedy is that of action for debt. This action is

15 See Chapter 11.

16 *Tailby v Official Receiver* (1888) 13 App Cas 523 (HL); and *Holroyd v Marshall* (1862) 10 HL Cas 191 (HL).

17 See Supreme Court Ordinance No 15 of 1844.





for a liquidated sum, not liable to be assessed by the court granting the judgment-debt, but is awarded as the sum promised to be paid by the debtor.

## 2.3 Examples of choses in action

### 2.3.1 The book debt

**[2-46]** Book debts are choses in action. Where the right to payment is embodied in a written form, as in the books of the company, the books themselves, or more correctly the chose, evidenced by the book entry, can be traded as if they were in effect, a financial asset.

**[2-47]** Receivables or book debts may be in writing, but this is not necessary to enable the creditor to sue on the debt. The book debt gives the creditor a claim against the debtor. The book debt is a right to be paid, and to take appropriate action on default, but it does not give the creditor any property interest over any asset of the debtor. Thus, there is no proprietary interest in the mere entry in the books of the company. Ultimately, on default, of repayment, the creditor would seek a judgment debt and then to attach that judgment to assets of the debtor, but that is not inherent in describing the nature of a book debt.

**[2-48]** The creditor has a right to sell or mortgage the book debt. It is commonly used as security by way of a floating charge when a company borrows money from a bank or other lender. This gives the lender a right not only to the book debt itself, but also to the more important and valuable aspect of that debt, namely the proceeds of payment of the debt. Depending on the nature of the charge, the lender will obtain priority over creditors of the company on its insolvency.

**[2-49]** The entry in the books of the company is treated as the present interest by way of a chose in action; and the proceeds of the debt, ie payment, are treated as future property. When lending to the company, the bank or other lender is more concerned with the question of the future property; generally, this requires the lender to ensure that there is control over the proceeds when paid. Exercising this control usually will require proceeds of the book debts to be paid into a designated account over which only the lender has control.

### 2.3.2 Other choses in action

**[2-50]** Various choses in action which are classified as 'legal', an historical division, are able to be dealt with at common law or in equity. The classification of property is influential in the type of security employed. Having classified it by reference to property, the next step is to determine who has rights in or over this property.

**[2-51]** The list of legal choses in action include:

(a) debts;
(b) book debts, or receivables;
(c) a right to an action in damages;
(d) a claim on an insurance policy;

(e) a bill of exchange;
(f) shares;
(g) money in a bank;
(h) trade marks and trade secrets;
(i) IP rights; and
(j) the common law lien.

**[2-52]** The list of equitable choses in action include:

(a) an equitable lien;
(b) a beneficial interest in an asset;
(c) a charge over an asset;
(d) an interest in a partnership;
(e) an interest in a trust fund; and
(f) money in a bank account.

**[2-53]** The distinction between legal and equitable choses in action is of limited importance today.

## 2.4 The nature of a chose in action

### 2.4.1 Choses in action evidenced by documents: In particular negotiable instruments

**[2-54]** With changes in commercial law and the needs of the marketplace, unsuccessful attempts have been made to treat a document representing a chose in action as a chose in possession. Thus, the document could be used as collateral security giving the lender an asset to seize and sell on default; by contrast with a chose in action, the lender would need to seek common law damages, or take action for a debt.

**[2-55]** Bills of exchange were given special characteristics by Law Merchant, and these were continued in the Bills of Exchange Ordinance (Cap 19). These characteristics, namely transfer of title by delivery, meant that a bill of exchange could be used as a possessory security. In addition, an action in tort in conversion would be available for unlawful interference with a bill of exchange. The action of conversion protects only choses in possession as the core of the action is unlawful interference with the possession of the owner in the item.

**[2-56]** But with other documents evidencing choses in action, such as a share certificate, the document merely evidences the right to a chose in action, and could not be used for a possessory security, and could not be protected by action for conversion on the trespass of another.

**[2-57]** In other words, relief for the abuse of a chose in action rests in contract; whilst relief for a chose in possession rests in a 'proprietary' action.

**[2-58]** In *Smith & Anor v Lloyds TSB Bank plc* [2000] 2 All ER (Comm) 693, it was said in relation to the Bills of Exchange Act 1882 that:

> By a legal fiction, a valid cheque is deemed to have a value equal to its face amount. This rule was explained by Scrutton LJ in *Lloyds Bank v Chartered Bank of India, Australia and China* [1929] 1 KB 40 at 55–56, [1928] All ER Rep 285 at 288:
>
> 'Conversion primarily is conversion of chattels, and the relation of bank to customer is that of debtor and creditor. As no specific coins in a bank are the property of any specific customer there might appear to be some difficulty in holding that a bank, which paid part of what it owed its customer to some other person not authorized to receive it, had converted its customer's chattels; but a series of decisions … culminating in *Morison's* case ([1914] 3 KB 356, [1914–15] All ER Rep 853) and *Underwood's* case ([1924] 1 KB 775, [1924] All ER Rep 230), have surmounted the difficulty by treating the conversion as of the chattel, the piece of paper, the cheque under which the money was collected, and the value of the chattel converted as the money received under it: see the explanation of Phillimore LJ in *Morison's* case.'





**[2-59]** In *Morison v London County and Westminster Bank Ltd* [1914] 3 KB 356 at 379, [1914–15] All ER Rep 853 at 865, Phillimore LJ stated:

> That the damages for such conversion are (at any rate where the drawer has sufficient funds to his credit and the drawee bank is solvent) the face value of the cheques is … so well established that it is not necessary to inquire into the principle which may underlie the authority. But the principle probably is that, though the plaintiff might at any moment destroy the cheques while they remained in his possession, they are potential instruments whereby the sums they represent may be drawn from his bankers, and, if they get into any other hands than his, he will be the loser to the extent of the sums which they represent. It may be also that any one who has obtained its value by presenting a cheque is estopped from asserting that it has only a nominal value.

**[2-60]** The classification of the asset as a chose in action remains the same, there is no metamorphosis into a chose in possession. Instead the transition enables certain choses, represented by the piece of paper evidencing the chose, to resort to proprietary remedies. This does not happen for all pieces of paper and in *OBG v Allan* [2008] 1 AC 1, [2007] 4 All ER 545 the House of Lords advised against an extension of this approach.

### 2.4.2 Choses in action as shares evidenced by share certificates

**[2-61]** A share is an intangible asset, a chose in action, embodied in a document, evidencing rights in respect of a company; it does not act as a document of title. Certain formalities are required to transfer title to a share to the transferee including execution of a document of transfer, and registration of the transfer in the company register of the company concerned. In *Marfani & Co Ltd v Midland Bank Ltd* [1968] 2 All ER 573 (CA, Eng) it was said that

> … by the series of legal fictions by use of which the lawyers of the sixteenth century evolved from the ancient real action of *detinue sur trover* a personal action on the case of trover which, with the abolition of the forms of action, became the modern tort of conversion. It may also seem odd that the basis of their liability is that the piece of paper on which the cheque was written was 'goods' belonging to the plaintiff company, and that the defendant bank's act in accepting possession of that piece of paper from [a third party], in presenting it to the [plaintiff's] bank and accepting payment of it, constituted an unjustifiable denial by them of the plaintiff company's title to its goods, from which damage flowed.

> Such, however, is the common law of England, and one of the consequences of the historic origin of the tort of conversion and its application to negotiable instruments as 'goods' is that the tort at common law is one of strict liability in which the moral concept of fault in the sense of either knowledge by the doer of an act that is likely to cause injury, loss or damage to another, or lack of reasonable care to avoid causing injury, loss or damage to another, plays no part.

**[2-62]** Bearer shares are *not* issued in Hong Kong. That form of a share certificate functions differently from the usual share because it is transferable (that is, title passes) merely by delivery of the piece of paper. The bearer share acts similarly to a negotiable instrument. The piece of paper can be taken possession of for security purposes, by pledge or where, by operation of law, a bailment of the share is converted into a common law lien.[18] This can occur where the share was held for a bailment of sake keeping, and the owner refused to pay fees for the safe keeping.

**[2-63]** The legal classification of a 'share' is that it is:

> the interest of the shareholder in the company measured by a sum of money for the purposes of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into all the shareholders *inter se* in accordance with s.16 of the Companies Act 1862. A share is not a sum of money asettled in the way suggested, but is an interest measure by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.[19]

**[2-64]** The share certificate identifies the person named as one of the shareholders of the company.[20] However, the share certificate does not include all the rights which are attached to a share. These rights, including a proprietary interest in the company, will pass only when the share certificate is registered in the register of members of the company.

A share certificate cannot be used as the subject of a possessory security. In general, the rights of the shareholder include a claim against the company for dividends, a right to vote, and to expect return for his capital investment. In some cases the certificate is referred to as 'documentary intangible', as representing the chose in action: see *Re Far East Structural Steelwork Engineering Ltd (In Liq)* [2005] 2 HKC 18.

**[2-65]** In general, the civil remedy for interference with the possession of a share will be an action for damages in contract, rather than a proprietary action in tort for conversion. The action of conversion lies only for property capable of being taken possession of; the usual complaint in conversion requires a corporeal asset: see *Silver Stone Development Ltd & Anor v Lau Kwong Ching James & Ors* [2007] 2 HKLRD 717, [2007] 4 HKC 77 (CA); and *Akai Holdings Ltd (In Liq) v Kasikhornbank PCL* (2010) 13 HKCFAR 479, [2011] 1 HKC 357 (CFA); and see generally *BBMB Finance (Hong Kong) Ltd v Eda Holdings Ltd & Ors* [1991] 2 All ER 129 (PC); and see also *MCC Proceeds Inc v Lehman Brothers International (Europe)* [1998] 3 LRC 599.

18 *France v Clark* (1883) 22 Ch D 830 (on appeal (1884) 26 Ch D 257); and see *Harrold v Plenty* [1901] 2 Ch 314.

19 *Borland's Trustee v Steel Brothers & Co Limited* [1901] 1 Ch 279, Farwell J at 288.

20 *Re Bahia & San Francisco Rly Co* (1868) LR 3 QB 584 (CA).





In *Silver Stone*, the court observed:

> [15] It is sufficient for the purpose of this appeal to state the following principles on conversion:
>
> (1) Conversion is an act of deliberate dealing with a chattel in a manner inconsistent with another's right whereby that other is deprived of the use and possession of it: *Clerk & Linsell on Torts* 19th Ed, para 17-07 and approved in *Kuwait Airways Corp v Iraqi Airways Co (No 4 & 5)* [2002] 2 AC 883 at 999.
>
> (2) Conversion must be conversion of corporeal personal property; choses in action cannot be converted: *China Everbright-IHD Pacific Ltd v Ch'ng Poh* (2002) 5 HKCFAR 630 per Lord Millett at 661.

**[2-66]** The House of Lords in *OBG Ltd v Allan* [2007] 4 All ER 545 (HL) referred to a suggestion that the tort of conversion should cover the appropriation of choses in action, including the benefit of a chose in action represented by a share certificate. However, the Court decided that to alter the existing law:

> would involve too drastic a reshaping of this area of the law of tort. The reshaping would be inconsistent with the basis on which Parliament enacted the Torts (Interference with Goods) Act 1977, after long consideration by the Law Reform Committee. It would have far-reaching consequences which this House is not in a position to explore or assess fully. This is an area in which reform must come from Parliament, after further consideration by the Law Commission.

**[2-67]** Unlike the position in England, there is no legislation, such as the 1977 Act referred to, in Hong Kong. Thus, questions of conversion rest on common law principles: see *China Everbright-IHD Pacific Ltd v Ch'ng Poh* (2002) 5 HKCFAR 630, [2002] HKCU 1481 (CFA); see also a reference in passim, in *Lo Li Li Lilly v Lui Fung He* [2016] 2 HKLRD 1460, [2016] 3 HKC 483 to the effect that on the facts of that case concerning a will 'we do not think the claims for conversion of the share certificates and intermeddling with the estate are unsustainable'.

**[2-68]** A recent decision in England has looked at a modern chose in action, namely an electronic database: the question was whether or not a common law possessory security, by way of lien, could be created over that chose: *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281. The Court of Appeal referred to the comment in *OBG* (noted above) and to the decision of the House of Lords in *Colonial Bank v Whinney* (1886) 11 App Cas 426 (HL) and held that there could be no lien because the asset was intangible and therefore, similarly to an action in conversion, could not apply to the electronic database and consequently to share certificates.

### 2.4.3 Can a share certificate be pledged?

**[2-69]** A pledge is a possessory security. The same implications arise as with the possibility of conversion of a share certificate: namely, can delivery of a share certificate, which is merely evidence of a benefit to a chose in action, amount to 'possession' of the document? Where the pledge is successfully created, the Court looks not at the non-physical attribute of the share certificate but instead ignores the apparent 'worthlessness' of the piece of paper, and concentrates on the underlying value and use able to be made of the share certificate.

**[2-70]** A share cannot be transferred under the Companies Ordinance (Cap 622) simply by delivery of the share certificate by the seller to the buyer. The certificate is neither a document of title, nor a bearer instrument. To transfer title to a share requires:

(a) a document of transfer which is ineffective to transfer legal title, until the transfer has been registered: s 150;
(b) application for registration in the registry of the company concerned, of that duly executed document. The response by the company register to the application must be given as soon as practicable, and at least within 2 months: s 151; and
(c) on default of that registration, application to the Court for registration. The company should give reasons for the refusal to register the transfer, and only when reasons are not given will the applicant apply to court: s 152.

**[2-71]** Until registration in the registry of the relevant company, the owner, as seller, is still registered so that the purchaser would have beneficial ownership but not legal ownership of the share: see *Hunter v Moss* [1994] 3 All ER 215 (CA, Eng); *Re Harvard Securities Ltd* [1997] 2 BCLC 369; and *First Laser Ltd v Fujian Enterprises (Holdings) Co Ltd & Anor* [2011] 2 HKLRD 45, [2011] 2 HKC 240 (CA).

The question of equitable ownership of shares was referred to in *Hunter v Moss*, and the decision in that case has been queried. In that case, there was a gift of 'trust' property to a beneficial owner. However, as there were doubts the identity of the trust property, it was not clear that the recipient would receive the beneficial estate. The will referred to 'the gift of 50 of my 950 shares'. But with which 50 of those shares was the gift concerned? The Court of Appeal reached a decision of 'workability'. In seeking to ascertain the sources of the trust, it was said that

> the question of certainty depends not on the application of any immutable principle based on the requirements of a need for segregation or appropriation but rather on whether one immediately after the purported declaration of trust, the Court could, if asked make an order or the execution of the purported trust.

The decision also noted that the subject matter would not have been certain if the declaration had been of a trust over 50 out of 950 bottles of wine.

**[2-72]** *Hunter's* case was criticised on the basis that there was no certainty in fact to which 50 shares the trust referred. However, Hunter's case has been considered in several jurisdictions: in Hong Kong see *Lo Man Kam v Law Man Wai* [2014] HKCU 2227 (unreported, CACV 250/2013, 23 September 2014) (CA).

**[2-73]** In *Re CA Pacific Finance Co (In Liq) & Anor (No 1)* [1999] 2 HKLRD 1, [1999] 2 HKC 632, Kwan J said that:

> It is well established that shares are simply bundles of intangible rights against the company which had issued them. Share certificates are not valuable property in themselves — they are just *evidence* of the true property, which are the proportionate interests of the shareholders in the ownership of the company.
>
> One pari passu share is exactly the same as another. This was recognised in *Solloway v McLaughlin*, where the Privy Council held that the broker need only have retained an equivalent quantity of stock in its possession, and in the more recent cases of *Hunter v Moss* [1993] 1 WLR 934 (Ch), [1994] 1 WLR 452 (CA) and *Re Harvard Securities Ltd* [1997] 2 BCLC 369. Therefore, each share certificate with HKSCC's depositary evidences the same bundle of rights, and each bundle of rights can satisfy the client's proprietary interest as any other.





The correct position is that the share certificate is merely evidence of a chose in action, and cannot be the subject of a pledge.

**[2-74]** The Australian Federal Court dealt with the question of the 'trust' in the context of unit trusts, an example of a collective investment scheme: *Commissioner of Taxation v Elecnet (Australia) Ltd Pty Ltd* [2016] 329 ALR 310 where it was said that:

> the unit trust emerged in 1866 as a collective investment vehicle; …early units were treated as shares. The discussion of the modern unit trust focused on 'functional descriptions based on history and practice'. So the two core elements were: did the named person have (a) a beneficial interest in the income or property of the trust estate, and was this interest (b) capable of being functionally described as involving units? The absence of the beneficial interest alone was not necessarily determinative.

The Court reviewed several reasons for a broad interpretation in such cases.

The reasoning in *Hunter v Moss* was not accepted in Australia, partly because judgment had been delivered *ex tempore*, ie orally at the end of the trial. The result of this form of judgment is often said to lack the considered and researched background found in most judgments delivered as reserved judgments after the trail when the judge has had time to review the proceedings. Australian courts decline to follow *Hunter v Moss* on the basis that 'the reasoning simply assumes, or asserts, that it is possible for a person to declare himself trustee of a particular number of shares he holds in a particular company' but without partiality as to which shares; this means there is not sufficient identification or allocation of the subject matter of the trust. Thus 'English law had departed from Australian law'. This point was made by the Chancery Court in *Re Harvard Securities Ltd* [1997] 2 BCLC 369 to the effect that 'Australian law produces a different result from English law' in such a case.

**[2-75]** In *China Field Ltd v Appeals Tribunal (Buildings)* [2009] 5 HKLRD 662, [2009] 5 HKC 231 (CFA) the Court referred to the role of the Court of Final Appeal as the final appellate bench for Hong Kong. It noted that (a) it could decline to follow a common law precedent from outside Hong Kong where the Court found that it had not been based on principle, and (b) where there was an alternative available and suitable to the inhabitants of Hong Kong. *Hunter v Moss* may be such a decision, and if the Court in Hong Kong declines to follow it, then the Australian decision in *Elecnet* requiring clear and precise identification of the subject matter of the trust could be applied in Hong Kong.

**[2-76]** See also the decision of the High Court of Australia in stressing the requirement of clear identification of trust property, in a mixed fund, in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd* [2000] 171 ALR 568.

## 2.5 The chose in possession

**[2-77]** By contrast to the chose in action, the chose in possession does have physical characteristics. It is movable, tangible, capable of physical possession:

# CHAPTER 10

# THE DEVELOPMENT OF RIGHTS FOR THE PURPOSE OF SECURITY

## 1. INTRODUCTION

**[10-1]** In recent years, developments in various areas including new subjects of investment such as derivatives, references to new examples of assets with consequent attempts to classify these assets such as 'carbon sequestration', the use of industry-standard form terms and contracts such as the ISDA ('International Swaps and Derivatives Association') Master Agreement, and the use of more sophisticated documentation, has required the re-assessment of many principles of contract and property law.

**[10-2]** The focus of this chapter is the various matters in identifying and classifying the novel interest, and how it is capable of being affected by a security transaction. The answers will be speculative.

**[10-3]** Matters to be considered include:

(a) the type of contract;
(b) the classification of the evolving 'asset';
(c) available remedies, dependent on whether the asset is proprietary or personal; and
(d) what remedies would provide the lender with adequate relief?

**[10-4]** Can the courts to be innovative, despite the rigidity, previously considered to be inviolate, of the three classifications of property under common law, of land (in Hong Kong as chattels real), chose in possession and chose in action?

## 2. NEW ASSETS AND THE COURTS

**[10-5]** The Courts seek to achieve a solution to concepts regarding new forms of interests that can be the subject of security. The rules may not be uniform or applied in a consistent manner. In some cases, there are no rules, and instead speculation, that a remedy exists, will be the basis of relief. In other *ad hoc* cases, courts have interpreted the traditional principles differently from the usual interpretation, to achieve a form of relief to accompany the right; an example of this type of relief is found in *Latec Investments Ltd v Hotel Terrigal Pty Ltd (In liq)* (1965) 113 CLR

265 (HCA). In that case, 'an equity to set aside for fraud', traditionally a personal interest, was converted into an equitable interest, or in modern terminology, a proprietary interest. This interest was to compete with the equitable interest of 'a bona fide purchaser for value without notice'. The holder of the equity lost the battle simply because the interest had not been protected before the bona fide purchaser took his interest. The failure to protect was due to a lack of funds on the part of the liquidator, rather than carelessness. But having elevated the interest, the court went no further. There was no attempt to also consider whether the bona fide purchaser rule required special application in such a case.

**[10-6]** The main purpose behind the classification of novel interests and rights is to ascertain whether the *res* or thing (or chose) can be considered an item of commerce making it of interest more to investors than to creditors. In seeking to introduce novel interests or rights, courts generally look backwards, apply precedent, and state that if it could not be done in the past, it cannot be done now. Reasons for the refusal are either because the elements of the interest claimed are inappropriate for the interest claimed, or because it has held that such a claimed interest cannot exist at common law. This leaves developments in the law for political, legal, or social reasons to the legislature. In *Hill v Tupper* (1863) 2 H & C 121, Pollock CB said that at 127–128:

> It would be a new species of incorporeal hereditament. It has been contended that this is a sort of estate, but the owner of an estate must be content to take it with the rights and incidents known to and allowed by the law. A grantor may bind himself by covenant to allow what rights he pleases over his property, but the law will not permit him to carve out his property so as to enable the grantee of such a limited right to sue a stranger in the way here contended for. For these reasons, therefore, our judgment will be for the defendant.

In *The Path of the Law* (1897) 10 Harvard Law Review 457, at 469, Oliver Wendell Holmes wrote:

> It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.

In *Bank of Montreal v Dynex Petroleum Ltd* [2002] 1 SCR 146, [2001] SCJ No 70, Martin J in delivering the judgment of the Supreme Court observed that:

> 17. The oil and gas industry, which developed largely in the second half of the 20th century and continues to evolve, is governed by a combination of statute and common law. The application of common law concepts to a new or developing industry is useful as it provides the participants in the industry and the courts some framework for the legal structure of the industry. It should come as no surprise that some common law concepts, developed in different social, industrial and legal contexts, are inapplicable in the unique context of the industry and its practices.
>
> 18. The appellant could not offer any convincing policy reasons for maintaining the common law prohibition on the creation of an interest in land from an incorporeal hereditament other than fidelity to common law principles. Given the custom in the oil and gas industry and the support found in case law, it is proper and reasonable that the law should acknowledge that an overriding royalty interest can, subject to the intention of the parties, be an interest in land.





**[10-7]** In previous chapters, mention was made of some 20th century innovations, such as the 'charge back' and s 15A of the Law Amendment and Reform (Consolidation) Ordinance (Cap 23) ('LARCO') which solidifies the interest, and of *Bank of Montreal v Dynex* (above) where the Supreme Court of Canada was able to convert a personal right into a proprietary right in land because: (a) the oil and gas industry treated the right in that way, and (b) the parties so intended. The later decades of the 20th century became inundated with various financial instruments, representing nominate interests, of which perhaps the derivative in all its forms was the most prominent. The trust became more versatile, saving the unsecured lender in *Barclays Bank v Quistclose Investments Co* [1979] AC 567 (HL) from *pari passu* distribution; in other cases, the bare or passive trust was well used to grant interests in land to a variety of beneficiaries. One of the most effective new 'interests', rather as a remedy than an interest per se, has been that of restitution, combining the legal 'quasi-contract' with the equitable 'unjust enrichment' to come up with an equitably fair and just remedy, under different names and forms: see, for example, the equitable compensation in *Akai Holdings Ltd (In Liq) v Kasikhornbank* (2010) 13 HKCFAR 479, [2011] 1 HKC 357 (CFA).

## 3. How is Property Classified?

**[10-8]** There are various ways to classify property – by reference to types, then by reference to examples within types, by the manner in which the interest can be interpreted by the courts, by the attributes of the interest and so on.

**[10-9]** *First*, under English law, the traditional *categories* of property, are *real property* and *personal property*. However, in Hong Kong *alienated* land is not classified as 'real property'; instead it is personal property as 'chattels real'. The only *alienated* land held by way of freehold is that on which St John's Cathedral is built, albeit title is subject to the terms of the Church of England Trust Ordinance (Cap 1014). The classification of property is relevant in determining whether an interest (and especially a novel interest) meets the demands of investors and creditors. The interests of a creditor, or an investor, relate to perfection, priority, and relief on default. The other forms of personal property are choses in possession and choses in action.

*Second*, when considering personal property assets, the most obvious difference is between tangible (movable) and intangible (immovable) objects. A chattel, as a chose in possession, is an example of tangible personalty. A chose in action is an example of intangible, personal property – even if the interest is evidenced by a document.

*Third*, various differences reflect the categorisation of the asset. Land, even as 'chattels real' is different from other property because it is permanent, it can be productive in providing income, as well as produce such as crops, and it can be dealt with in a variety of ways. Apart from rare or specifically manufactured items, goods can be fungibles; this means that the relevant goods can be replaced by equal quantities of the same type, and usually can be traded by weight, or number, or measure. Goods can be present or future, ascertained or unascertained. This classification enables future property, or after-acquired property, to be the

subject matter of a floating charge given by a company (acquiring the goods in the future) prior to that acquisition. The category of personal property, namely chose in action, is more elusive as the chose gives a right to action to sue so as to 'obtain' the interest of the chose. The common form of a chose in action used as security by a company is a book debt; the entry of the existence of the debt in the books of the company represents present property whilst the proceeds of the book debts, prior to payment, represent future property. Only equity can provide protection to the chargee of a charge of 'future' property. This resulted in the development of the 'equitable charge', most commonly used by commercial parties to finance their affairs.

*Fourth*, rights in assets or in property can be divided into two main categories, namely rights *in personam* and rights *in rem*. *In personam* rights are enforceable against the parties to the transaction; *in rem* rights are rights in the asset largely 'good against the world'.

*Fifth*, property rights cut across various areas of the law, and therefore across various barriers inherent to different areas of the law; these barriers include principles relevant to contract and tort where the interest or right is created by agreement, or by wrongdoing, or by reference to a dispute.

*Sixth*, property rights consist of:

(a) a bundle of rights of ownership, use, or enjoyment over goods, land or chose in action. These are given different terms; for example: for goods, the terms 'title' and 'property' indicate ownership; and
(b) responsibility for others in respect of these rights.

**[10-10]** The rights then:

(a) give a right to a remedy on loss or damage;
(b) in certain cases, can give;
    (i) the right to assign to third parties;
    (ii) to be enforceable against a third party;
    (iii) to be enforceable by a third party;
(c) the ability to unlawfully interfere with the possession of the owner, the occupier, or the person in possession;
(d) can be equitable or legal;
(e) recoverable by action; and
(f) generally, capable of being owned, given as a gift, mortgaged, charged, leased, and so on.

In recognising novel or new examples of rights, the general rule is that the divisions of *in personam* or *in rem* rights will be retained, unless re-classification is relevant to giving the relief sought. The '*res*' or thing identified can be a personal right, or an example of a recognised category of rights or interests, or the source of a new category. However, in many cases, attempts to create new rights are defeated by the statement that the 'categories are closed' so new examples of the old right can be established in the twenty-first century.





## 4. The Debt to Mercantile Law

**[10-11]** Mercantile law, and then the common law into which mercantile law was subsumed, recognised various 'things' or 'choses' as commercial assets able to be dealt with, for example to be sold, leased, mortgaged and given as gifts. These are classed as one example of personal property, and of the sub-category as chose in action. Frequently these 'assets' are evidenced by some document; for example:

(b) certain 'financial' assets; for example a promissory note;
(c) the interest evidenced in a share certificate;
(d) a credit balance in the bank;
(e) choses in action 'reduced' to a dematerialised form by entry into a register; and
(f) an entry in the records of a clearing house.

The presence of 'paper' does not elevate these interests beyond their basic characteristics as choses in action. The common law treats these and other examples of intangible interests as objects, ie as things, because people are willing to buy them. Mercantile law ultimately as part of the common law, required anything that was an object of commerce to be treated as a recognisable asset for the purpose of relief on default. Outside land law, commercial investors and speculators devised innovations using the traditional forms of assets, and leaving it to lawyers to fit these commercial interests belatedly into some scheme of recognition and protection.

**[10-12]** Other pieces of paper may have 'magical' attributes, such as the Bill of Lading which for centuries has been the manifestation of the contract for the carriage of goods by sea, but which is treated as a document of title to the goods: 'he who holds the Bill holds the goods'. This was the only common law document of title to goods. Statute provided for other such documents, for example under early examples and current Bills of Sale legislation, including the Bills of Sale Ordinance (Cap 20). Generally, these inventions and innovations have been based on traditional principles of the law but by applying these in a different way; see for example, *Bank of Montreal v Dynex Petroleum Ltd* [2002] 1 SCR 146, [2001] SCJ No 70. Other courts have expanded existing doctrines to offer newer versions of the old form, thereby expanding the effect and operation of the former principle: for example, the 'wilful blindness' concept expands the notice rule in equity;[1] or the concept of 'knowing assistance of a breach of trust' from *Barnes v Addy* (1874) 9 Ch D 244 metamorphosed into a remedy for damages in tort based on dishonesty.[2]

## 5. Assets as Items of Security

**[10-13]** An investor or creditor may well find that the nature of the asset is irrelevant; and instead the classification concentrates on the strength of the contract in creating the possibility of relief which, in line, with modern developments, may

1 Also known as contrived ignorance or 'Nelsonian' knowledge: *Akai Holdings Ltd (In Liq) v Kasikornbank PCL* [2010] 3 HKC 153 (CA).
2 *Royal Brunei Airlines v Tan* [1995] 2 AC 378 (PC).

produce substantive relief. To the investor, the important aspect is whether the asset or the right will enable recovery of any money expended or lent. This has been broadened by developments in recent years, especially in regard to equitable relief, where the courts have granted relief in ways that are seemingly impossible but which do justice to the problem: these include:

(a) granting an account of profit and calling it 'common law damages';
(b) restitution to replace the traditional difficulty with quasi-contract eliminating the need for an implied promise, and not punishing the existence of an express promise; and
(c) acting to prevent the defendant receiving a windfall;

**[10-14]** By and large, the novel interests in this chapter are those which an investor, rather than a creditor, will be interested in financially. These are able to be the subject matter of a security or quasi-security contract by some innovative measures by the courts to achieve a worthwhile remedy.

**[10-15]** An example of this exercise is that of fitting the interests of a floating charge into the traditional classification of chose in action.[3] By the end of the 19th century, often the book debts of a company represented the only available asset for the purposes of a security. How were they to be classified? These are an amalgamation of present property, namely the entry in the books of the creditor of the details of the debt. The book debt gave no relief at common law because whilst the entry in the books could be covered, it was valueless. What could equity do to provide an effective remedy to the lender? The proceeds of the book debts represent the real value of the book debt but until the debt is repaid, the debt represents only a right to future or after-acquired property.[4] Equity acting on one of its maxims to the effect that 'equity looks on that as done that which ought to be done', treated the company as a trustee for the lender as soon as the debt was repaid to the company, but until then, the company could not deal adversely to the lender's interest in the book debt due to the principle that the 'conscience' of the company prevented it from ignoring the lender's interest. This development made possible the lending of money in respect of these rights *in futuro* because equity acts on the conscience of the borrower who breaches the terms of the trust. The factor, which facilitated the invention of the floating charge, was the approach of equity to future property. Future property is that which is not presently in existence, or which is not presently owned by the party seeking to deal with it. Common law could not recognise this property as it did not exist. If the borrow wished to use this property for security, common law required entry into a contract, and later when the property came into the hands of the borrower, there had to be delivery to the lender to perfect the loan. But because equity overcame this problem in 1862 by treating the interest of the borrower in the future property as equitable and capable of being charged,[5] the use of future property became possible, because equity would 'look on that as done that which ought to be done'. When the property came into the hands of the borrower, he held it as trustee for the lender.

3 *Re Yorkshire Woolcombers* [1903] 2 Ch 284 (CA, Eng).
4 *Holroyd v Marshall* (1862) 10 HL Cas 191 (HL).
5 ibid.





**[10-16]** The common law and equity are not strangers to developing forms and procedures when needed. The nineteenth century was a time of great legislative activity involving commercial matters, and this was so mainly because of the innovative manner in which the law adapted to then modern problems. It was also a time in which codifications of earlier enactments based on law merchant were enacted. In 1853, the Royal Commission in the United Kingdom had set up a committee to 'inquire and ascertain how far the merchant laws of the different parts of the United Kingdom of Great Britain and Ireland may be advantageously assimilated'. The legislation which was produced in the next few decades covered most areas of mercantile law either by the updating of existing legislation, or by new regulation in the form of codification of mercantile law principles. The Bills of Exchange Act, the Sale of Goods Act, the Bills of Sales Acts were all examples of legislative forms of mercantile law practice which Hong Kong soon adopted.

**[10-17]** At this time, there were developments in England in the regulation of the affairs of corporations through a series of enactments such as the Stock Companies Act 1844, the Companies Clauses Act 1845, the Limited Liability Act 1855, the Joint Stock Companies Act 1856, and the Companies Act 1862, leading onto the Companies Act 1900 which is the framework for modern company law. The developments in company law showed the necessity for innovation in dealing with the assets of a company in various ways, not only in relation to the share itself, but also in relation to the use of the asset in company borrowing. These too were ultimately followed in Hong Kong.

**[10-18]** Whilst the traditional form of security over land, namely the mortgage, was available to a company in respect of its land, problems were increasingly found when dealing with other assets, in particular the stock-in-trade of a company. To overcome these problems, equity allowed the invention of the floating charge. The floating charge had the great advantage of allowing the borrowing company to continue dealing with its stock-in-trade in the ordinary course of its business even though the company's assets, its 'undertaking', were subject to a security interest in favour of the lender. The three characteristics of the floating charge were described in *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284, Romer LJ at 295 as:

(1) If it is a charge on a class of assets both present and future;
(2) if that class is one which in the ordinary course of the business of the company, would be changing from time to time and
(3) if it is contemplated by the charge that, until some future step is taken by or on behalf of the mortgagee, the company may carry on its business in the ordinary way as far as concerns the particular class of assets charged.

In 1897, this floating charge had been described as being an:

> equitable charge on the assets for the time being of a going concern. … It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes. [6]

6 *Government Stock & Co Ltd v Manila Railway Co* [1897] AC 81 at 86 (HL).

## 6. A Modern Example of Environmental Rights and the Kyoto Protocol

**[10-19]** There are perhaps three matters of concern when a court is asked to deal with a novel interest. These matters may well be treated differently when one is considering a traditional form of property, as opposed to when considering novel interests. These are:

(a) *Risk*: what form of security should be taken to ensure the greatest protection to the creditor as against the debtor, and those taking through him including on insolvency?
(b) *The nature of money*: is it a physical chattel in all cases? Is it to be treated as a fungible? This is so especially in relation to derivatives where the 'loan' may be an electronic entry only.
(c) *Taking rights in property*: are these really rights against the parties, rather than rights in property?

**[10-20]** How are environmental rights, exemplified here as: (a) the trading of emission permits, (b) carbon credits and (c) carbon sequestration rights, to be classified? Can they be used as items of security? These 'assets' are essential to international programmes seeking to achieve 'clean air', as formerly established in the United Nations Framework Convention on Climate Change ('the Kyoto Protocol'). The Protocol provided that countries that did not adopt the Protocol were not subject to the Protocol's requirement of reducing greenhouse gas ('GHG') emissions. The failure of several countries to adopt the Protocol resulted in a weak system. Later international programmes, such as the Paris Agreement, sought to achieve the universal targets, also without universal success.

**[10-21]** The Kyoto Protocol introduced new terms into our language. It defined three main concepts as:

(a) *A 'reservoir'* which means 'a component or components of the climate system where a greenhouse gas or a precursor of a greenhouse gas is stored';
(b) *A 'sink'* means 'any process, activity or mechanism which *removes* a greenhouse gas, an aerosol or a precursor of a greenhouse gas from the atmosphere'; and
(c) *A 'source'* means 'any process or activity which *releases* a greenhouse gas, an aerosol or a precursor of a greenhouse gas into the atmosphere'.

**[10-22]** The Kyoto Protocol added to these definitions so that:

> A 'carbon pool' means a reservoir; a system which has the capacity to accumulate or release carbon. Examples of carbon pools include forest biomass, wood products, soils, and atmosphere. In other words, this is a sink. 'Sequestration' means the process of increasing the carbon content of a carbon pool other than the atmosphere.





**[10-23]** A 'sink' stores whilst a 'source' releases harmful carbon and other greenhouse gases. Sequestration occurs in plant growth as carbon is captured in the formation of plant cells, and oxygen is released. Although a forest is the main example of a sink, the ocean, grasslands, rocks, and waste dumps can also function as sinks where the process of sequestration occurs. The process is slow but when deforestation occurs, the loss is swift and unless the wood remains identifiable as a wood product, the loss is permanent. Even if reforestation takes place, the build-up of a sink will be a slow process and any sequestration will be less than that which was contained in the original forest.

**[10-24]** The focus of the scheme was that:

(a) the holder of an emission permit would be entitled to emit a specified amount of GHGs; and
(b) that permit can be traded as any other chose in action.

This established the permit as an item of property, although traditionally this form of property was unknown. Where permits are surplus to domestic emission, the permit could be traded to those who could not meet their caps.[7] The Kyoto Protocol also devised 'flexible mechanisms' to seek to achieve the goal of cleaner air. Another decision, for this purpose, concerned carbon sequestration trading rights.

**[10-25]** The overall aim of this regulation was designed to reduce GHG emission by setting the rates of permits lower than existing emission in the Annex B countries (that is the 39 developed or industrial countries) by capping the total emissions permissible for each country within that group.

**[10-26]** Carbon sequestration trading rights ('carbon right') are rights created in respect of the sequestration of carbon dioxide in carbon sinks which take in carbon dioxide from fossil fuel burning, from deforestation where forests are cut down but not replanted, from animals and so on. Where the carbon is trapped in a sink, it acts as a carbon credit quantified by reference to the amount of carbon stored. This credit can then be sold to those who seek to exceed their emission permits.

**[10-27]** The classification of the 'carbon right' was a matter for each signatory government, in line with the law of the country, and other relevant matters. In classifying the right, questions include:

(a) is the right proprietary or personal? At common law, the question then arises as to whether the 'list' of real or proprietary rights is closed;
(b) is the right statutory? If so, the statute can attribute elements to it, how do these attributes fit within the property system?
(c) is the right recognised at law and in equity? and
(d) does the right have physical characteristics so that possession of it may be taken?

7 Articles 3, 6, and 17 of the Protocol.

**[10-28]** Different solutions were used in different countries. For the common law, the easiest is probably to enact legislation classifying the asset as a 'proprietary' interest capable of statutory protection for priority and effect under that legislation. For example, ss 87A, 87AB, and 88EAA were amended in the Conveyancing Act (NSW) to treat the sequestrated right as *a profit a prendre*, which makes it a proprietary interest, capable of being assigned and dealt with as a valuable interest according to the ordinary rules of property law.

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**Points to note and exercises:**

1 Would 'law merchant' in its original form, that is evidencing the customs of merchants, assist in classifying novel interests?
2 Are novel interests really 'political interests'?
3 What security does a lender receive when the subject of the collateral security is a novel interest?



# CHAPTER 11

# REAL SECURITIES: THE MORTGAGE

## 1. INTRODUCTION

**[11-1]** This chapter describes one of the four 'real' securities, namely the mortgage. A mortgage is a traditional form of security, collateral to the contract for the loan of money. It was formerly used almost exclusively when the asset being secured was land, so the elements often reflect that origin. It is a versatile form of security and can be used over land, chattels, and the benefit of a chose in action. The relevant principles relating to mortgages depend on common law, statute, and especially in relation to remedies, on equity. There are two elements to a mortgage, namely the contractual and the security aspects. The security interest prevails because it is proprietary and gives rights over the secured property, rather than merely personal rights in contract. Covenants relating to repayment of the loan can be dealt with by contract; either through action for common law damages or an action for debt. Covenants relating to the security element are dealt with through proprietary remedies, usually the sale of the subject asset. Hence principles of contract, equity, and property are relevant in considering this transaction.

**[11-2]** In summary, a mortgage deals with:

(a) Title: The transfer of title to the mortgagee subject to (i) the right to redeem, and (ii) the equity of redemption;
(b) Posession: Usually remains with the mortgagor, until default: the mortgagor holds as a licensee, or tenant, or by attornment;
(c) Perfection: For land requires the form of a legal charge. The mortgage/charge is registered under the Land Registration Ordinance (Cap 128) not for perfection, simply for notice and priority. For goods on an individual registration of a Bill of Sale. In other cases, the form used may provide perfection. A mortgage by a company requires registration under s 335 of the Companies Ordinance (Cap 622);
(d) Default: The main remedy is sale of the mortgaged asset. As the mortgagee has title, he is able to pass title to the purchaser;
(e) Assets: Land: Goods: The benefit of a chose in action;

(f) Remedies: Sale: Possession: Action for debt: last resort action for common law damages;

(g) Discharge: Under the Conveyancing and Property Ordinance (Cap 219) a release which is then registered under the Land Registration Ordinance (Cap 128) to remove the encumbrance of the mortgage/charge on title.

The element in the transaction which makes the mortgage a 'real' security is that the asset 'pledged', and for which the title passes to the mortgagee, is available for sale on default, converting the monetary claim and remedy of the lender into an *in rem* claim against the asset. The term 'pledge' was used to describe early mortgages, but there was no physical transfer of possession, instead potentially the mortgagee could take possession. The term 'pledge' is now used solely when possession passes as with a pawn of goods.

**[11-3]** This chapter deals briefly with the forms of mortgage. The remedy of sale on default under a land mortgage is dealt with in the chapter on Charges because the modern legal mortgage of land takes the form of a charge but it does retain most of the incidents of a traditional mortgage.[1] The contents of this chapter will enable a contrast to be drawn between the other real securities, and those of the group of securities referred to as 'quasi-securities'. The mortgage under s 44(1) is described here as the 'mortgage/charge' and the mortgagor as the 'mortgagor/chargor' and the mortgagee as the 'mortgagee/chargee' to distinguish the statutory, legal charge from the traditional mortgage over land. An equitable mortgage retains the traditional attributes of such a security, and the equitable charge, retains the encumbrance nature of that security. Therefore, there is no need to change the name of these interests in this chapter.

## 2. Charge vs Mortgage

**[11-4]** Because of the mixture of terminology and principles associated with the security over land in Hong Kong as seen in s 44(1) of the Conveyancing and Property Ordinance which refers to a 'legal mortgage by way of legal charge by deed' over land where the legal mortgage is created in the form of a charge by deed; this is referred to as the 'mortgage/charge'. Section 44(2) then attributes all the relevant incidents of the traditional mortgage into this mortgage over land so long as it is created in accordance with s 44(1). This security is in form a charge but in substance a mortgage. This contrasts to the equitable charge over all types of personalty, namely chose in possession as well as the benefit of a chose in action, which is dependent on equity for enforcement. By contrast, an equitable charge over goods or the benefit of a chose in action, requires a judicial order to enable the chargee to sell the asset on default. To overcome this deficiency with the equitable charge, it is common to give the chargee power to deal with the asset directly by the grant of a power of attorney or execution by the chargor of a blank assignment.

1 Section 44(1) of the Conveyancing and Property Ordinance.





**[11-5]** There is no restriction on creating a floating charge (in the sense of an equitable, not a statutory, charge) over land in Hong Kong. However, s 56A expressly provides that a floating charge does not fall within the protective and empowering provisions of the Conveyancing and Property Ordinance until the charge has crystallised; further, s 2A of the Land Registration Ordinance prevents registration until that crystallisation has occurred. Regardless of s 2A, a charge, floating or when crystallised as a statutory mortgage, over company property must be registered under s 335 of the Companies Ordinance (Cap 622). It is possible to create an equitable mortgage or equitable charge over land under the Conveyancing and Property Ordinance either because the mortgagor only has an equitable interest in the land, or because the deed used is defective, or because the parties so intend. The deficiency of an equitable charge over land is that it does not get the benefit of the statutory power of sale. The mortgagee must seek a judicial order for sale. To avoid this, a sensible mortgagee requires the mortgagor to appoint the mortgagee (or his nominee) an attorney under power, or executes a blank assignment at the time of the advance of the loan money.

**[11-6]** The mortgage in the traditional form, with transfer of title and two 'equities' of redemption, is no longer used in respect of land; the charge, providing merely for an encumbrance against the land, has taken its place. Section 44(2) provides that subject to a contrary intention of the parties, that charge has all the elements of a traditional mortgage save that the chargee may not take physical possession until default. The two 'equities' of redemption are: (i) the common law right to redeem under the contract for which time is of the essence and on default of repayment on the due date, the right of the chargor to redeem is destroyed; and (ii) equity's indulgent right to redeem which extends the time for repayment for six months, thereby keeping the charge alive to enable the chargor to seek further finance. Traditionally, the remedy for an equitable mortgage was foreclosure, by judicial order. The more common equitable security these days would be the equitable charge; when created by deed, the chargee has the statutory remedies provided for by the Conveyancing and Property Ordinance other than the power of sale.[2]

**[11-7]** Whilst the mortgage over land has fallen into disuse, it is possible to have a mortgage over a chose in action or a chose in possession. It is not common to do so, but it is available. The form of a mortgage over a chose in action can be that achieved by a statutory assignment of the benefit of that chose in accordance with the terms of s 9 of the Law Amendment and Reform (Consolidation) Ordinance (Cap 23). In respect of goods, it is possible to have a mortgage over 'personal chattels' owned by an individual under the Bills of Sale Ordinance (Cap 20). The Ordinance is rarely relied upon as it is a complex, old-fashioned method of giving notice 'to the world' on registration of the mortgage under that Ordinance.

2 Section 51(3).

# 3. The Traditional Mortgage

## 3.1 The nature of the traditional mortgage

**[11-8]** A mortgage gives the creditor, *qua* mortgage, rights over the mortgage property, although the debtor normally keeps possession; in effect, the creditor under the legal mortgage becomes the legal owner of the property (subject to the equity of redemption). Under an equitable mortgage, the mortgagee does not obtain legal title to the mortgaged property but does obtain rights in equity over the asset, which may result in the legal title, and the property, being subject to the terms of the equitable mortgage. The source of the security is the asset linked to the repayment of a loan. Title to the property is assigned to the lender, *qua* mortgagee, whilst generally possession remains with the borrower by consent or permission of the lender *qua* mortgagee, or by attornment by the borrower *qua* mortgagor, until default when the mortgagee can take physical possession and sell the land. This consent can be given formally, or by implication from the terms of the contract, or subject to attornment between the mortgagor and mortgagee. Reference to the right of the mortgagee is often referred to as 'title paramount'.[3] The contract between the parties can alter this factor as they wish so that the mortgagee may, by contract, be given physical possession prior to default.

**[11-9]** In *Ryall v Rolle* (1749) 1 Atk 165, 26 ER 107, it was said in relation to the mortgage of goods (and the comment is, to some degree, applicable also to a mortgage of land) that if possession of the chattels does not pass to the mortgagee, some form of publicly recognised protection is necessary. For example, the Bill of Sale was the form commonly used for this purpose for both consumer and company mortgages. This gave notice 'to the whole world' when the bill of sale was registered in accordance with the legislation. However, in the later part of the nineteenth century, the companies legislation provided for registration under that legislation for company mortgages or charges, and the Bills of Sale legislation expressly provided it did not apply to company mortgages over chattels.[4] *Ryall v Rolle* (above) distinguished a mortgage from a pledge of chattels.[5] The distinguishing feature was said to be that the mortgagee immediately gained title to the chattels (subject always to the equity of redemption) whereas with the pledge no title passed. The pledgee gained a 'special property' in the chattels as part of the passing of possession to him.

**[11-10]** Although the mortgagee/chargee does not gain physical possession of mortgaged/charged land pending default, his interest is referred to as that of 'title paramount' possession.[6] For chattels, owned by a corporation, registration under s

3 See *Matthey v Curling* [1922] All ER Rep 1 (HL); and *Typhoon 8 Research Ltd v Seapower Resources International Ltd & Anor* [2001] 3 HKLRD 773, [2001] 4 HKC 311, on appeal on a different point: [2002] HKCU 906 (unreported, CACV 2980/2001, 30 July 2002).

4 See s 26 of the Bills of Sale Ordinance.

5 And see the Companies Clauses Ordinance 1854, Schedule C.

6 See *Typhoon 8 Ltd v Seapower Resources International Ltd & Anor* [2002] HKLRD 600, [2002] HKCU 906 (CA).





335 of the Companies Ordinance (Cap 622) will provide some protection, and for 'personal chattels' of an individual, the Bills of Sale Ordinance will provide that protection when there has been compliance with its terms.

## 3.2 Traditional terms

**[11-11]** Traditionally, a mortgage was described as:

> a conveyance of land … as a security for the payment of a debt or the discharge of some other obligation for which it is given. This is the idea of a mortgage: and the security is redeemable on the payment or discharge of such debt or obligation any provision to the contrary notwithstanding.[7]

From the earliest of times, this mortgage was effected over land when the landowner borrowed money (under a loan contract) and used his land as security for repayment, namely as the collateral for the loan. The main asset of the borrower generally was his land; and that land was often agricultural land producing income. Land has always been marketable, ensuring the lender would recover in cash on repayment, or by the sale of the land, when the mortgagee exercised his power of sale on the mortgagor's default. The 'provision to the contrary' to which Lord Lindley referred was that of the 'clog on the equity of redemption'. This was a restrictive covenant limiting the right of the mortgagor, on repayment, to recover the land, or to recover it subject only to an encumbrance, or to delay recovery.

**[11-12]** A 'third party mortgage' is the same structure as any mortgage. The only difference is that the owner of the asset is not the borrower (nor the recipient of the loan money) but a third party who is mortgaging his own land for the benefit of the borrower. This may be accompanied by a guarantee or an indemnity, entered into by a third party, to further enhance the mortgagee's power to recover the money lent, and probably also payment of interest thereon.

**[11-13]** The mortgage is a *real* security as well as a contract. Usually the contract is one for the loan of money as a separate obligation from the security contract. The loan contract contains a personal covenant for the repayment of the debt. This personal debt obligation remains extant, if unsatisfied, despite the sale of the mortgaged asset by the lender on default under the mortgage. The preservation of the personal obligation is complementary to the lender's power to return the property on repayment, or any surplus on sale; both of these represent the equity of redemption. But once the lender is unable to return the property or money equivalent to the equity of redemption, from the surplus money on sale, as happens on foreclosure, the personal covenant, even if unsatisfied, is extinguished. If the proceeds from the sale was insufficient to repay the debt, the debt remains payable despite the sale of the secured asset. The mortgage is both a contract and a transaction of security under which an interest in land is created. The contract part of the transaction is governed by general contractual principles. The common law rule provides that time, for the performance of the terms of this contract, is of the essence meaning that failure to perform timeously will generally terminate

7 *Santley v Wilde* [1899] 2 Ch 474, Lord Lindley MR at 474.

the rights of the mortgagor under the contract, including that of redemption by allowing the mortgagee to foreclose and take absolute title in the land. Equity intervenes by extending the time for repayment under the equity of redemption but does not do so indefinitely. Foreclosure extinguishes the equitable interest of the mortgagor forever, thereby merging the legal title to the asset which the mortgagee already has with the beneficial interest. However, if the mortgagee has been guilty of fraud, for example, and he later seeks to sue the mortgagor for outstanding amounts, then the court will reopen the foreclosure and make the appropriate order.

**[11-14]** The security interest results from the assignment of the legal estate to the mortgagee, not absolutely, but subject to: (a) the creation of the contractual equity of redemption for which time is of the essence; and (b) later, where equitable intervention is still needed to assist the borrower, the equitable right to redeem. These rights result in the mortgagor retaining, on entry into the mortgage, an equitable or beneficial interest in the land. The presence of the security element has two main effects: first, it enables relief against the land itself and, second, it enables the intervention of equity in equity's role of relieving against the ancient 'penal bond'. The penal bond was a deceptive encumbrance of the right to redeem, created by money lenders to circumvent the prohibition on usury post-1190.

## 3.3 The form and effect of a traditional mortgage

**[11-15]** Traditionally a mortgage of land in England took the form of:

(a) A conveyance, as collateral to a loan contract, which contained a proviso for reconveyance on repayment: there were two parts to this proviso. The first part was the common law right to redeem theland on repayment on ort before the due date; the second part was the equitable interest or estate in the mortgagor protecting his right to redeem his land which allowed the extension of his right to redeem beyond the due date under the Equity of Redemption, subject always to Equity's discretion in granting the extension of time; and

(b) Various covenants were included in the mortgage, and in the loan contract, including those relating to the requirement of the mortgagor to ensure the property retained its value whilst the mortgage remained unpaid, relating to the rights of the mortgagee to possession but allowing the mortgagor the right to remain on the land pending default either by attornment (as the mortgagee was considered to have 'title paramount' to possession) by licence or by lease, relating to repayment of the principal sum borrowed and interest thereon, and other relevant covenants.[8] The courts would allow, and would enforce, various terms so long as there were not illegal, or void for uncertainty, or represented a clog on the equity of redemption. Further any term which altered the inherent nature of a mortgage could result in the transaction being treated as merely contractual rather than as creating a secured interest.

**[11-16]** The traditional mortgage deed:

(a) imposed an obligation to repay the principal and to pay interest;

(b) created an equitable interest enabling redemption on repayment;

(c) gave the control of possession to the mortgagee who usually permitted the mortgagor to retain possession pending default. The right to remain needed a legal basis and this was provided either by the creation of a licence in favour of the mortgagor, or the grant of a lease to him, or an attornment[9] clause in the mortgage deed;

(d) contained covenants for title whereby the mortgagor covenanted (therefore creating a separate contract) that he had title to the land, and so on. Where the covenant to repay remains valid it is the responsibility of the mortgage, or his personal representatives, even if the equity of redemption has been assigned. This would occur where the asset subject to the mortgage has been transferred to another. In such a case, the mortgagor should obtain an indemnity from the assignee in respect of any liability to the mortgagee.[10] However if the assignee, from the mortgagor, and the mortgagee execute a renewal of the mortgage then the original mortgagor is discharged from the covenant. In other words, there has been novation between the incoming mortgagor and the mortgagee.[11]

In *The English Scottish and Australia Bank Ltd v Phillips* (1937) 57 CLR 69 (HCA), the transferee of a mortgage took action to recover the mortgage debt under the personal covenant. The court confirmed that in the absence of the personal covenant, a simply contractual debt will be implied into the mortgage. The second part of the covenant is to pay interest. Common law provides that a bank can charge interest on a loan without expressly so providing in the mortgage because this reflects the business of a bank in lending money for a profit. For non-bank lenders, it is necessary to insert into the contract a covenant on the part of the borrower to pay interest on unpaid principal. On default of such covenant, no interest may be charged.[12]

## 3.4 The essence of a modern mortgage

**[11-17]** The essence of the mortgage then consists of:

(a) The use of the property as security for or as an earnest of the repayment of a debt, and of any interest lawfully required.[13] The

8 See *Mills v United Counties Bank Ltd* [1912] 1 Ch 231(CA) and *Waring v Ward* (1802) 7 Ves 332.

9 See Chapter 4, and see *Re Hang Fund Jewellery Co Ltd* [2010] 2 HKLRD 1, [2010] 2 HKC 301.

10 *Mills v United Counties Bank Ltd* [1912] 1 Ch 231.

11 *Rouse v Bradford Banking Co Ltd* [1894] AC 586 (HL).

12 See *Islamic Press Agency Inc v Al-Wazir* [2001] EWCA Civ 1276.

13 *Sempra Metals Ltd v CIR & Anor* [2007] UKHL 34.

modern approach to the assessment of interest was referred to in *Sempra Metals Ltd v Revenue and Customs Comrs* [2008] 1 AC 561 (HL). There, the plaintiff was owed money by the CIR for overpayment of inland revenue under mistake of law. The questions for the court were: how much, and whether it was interest free, and if not then was interest simple or compound? The claim was reframed when it reached the House of Lords as one in restitution, rather than in damages. One result of this was that the usual, six year limitation was able to be extended so that limitations began only when the mistake was discovered. The general principle was that no compound interest was payable. However, the House of Lords in *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] 2 All ER 961 had said that compound interest was sometimes necessary to achieve full restitution and a just result. In *Sempra* the Court awarded 'common law damages' assessed on the basis of 'time value' of the detention of the company's money thereby satisfying those looking to equity and restitution; and those confirming there was no right to interest, compound or otherwise, in such cases.

The principle behind assessment of the amount payable was that the plaintiff had lost the use of its money – here referred to as 'time value for the use of the money' – rather than that the defendant had gained the money. Common law would not award interest; but as Lord Nicholls said: 'the common law should sanction injustice no longer'. The other Law Lords agreed. The effect of this was that compound interest was available for late payment of a debt, and so compound interest was, in principle, also available for restitutionary claims. The defences of change of position was available to the defendant if such circumstances existed: and see *Deutsche Morgan Grenfell Group plc v HMRC* [2007] 1 All ER 449 (HL) where the same type of claim was referred to in cases of payment under mistake of law, as unjust enrichment where there was an absence of legal grounds justifying retention of the benefit.[14]

(b) The personal covenant to repay which is linked with the ability of the borrower to recover his property, and which is to some extent independent of the security element. This contractual covenant is applicable to the mortgage/charge.

The personal covenant to repay is a contractual obligation which survives the sale of the asset if the sale proceeds are insufficient to repay the debt. Action can be taken in debt for the amount due. Whilst it would be possible to take action for common law damages for non-payment, there are two inherent difficulties with

14 See *Patel v Mirza* [2017] 1 All ER 191 (SC) where it was said that restitution of money paid under an illegal contract which had not been performed was recoverable because there were no equitable barriers to restitution in favour of the plaintiff.





such an action. First, the mortgagee would have to prove loss based on *Hadley v Baxendale* [1843-60] All ER Rep 461; this may now mean a merger of the first and second legs (thereby increasing any possible 'loss') but still the underlying concept of 'loss' suffered by the breach of the contract by the borrower must be maintained. The second element is that the lender suing for damages had to mitigate his loss; that is, he had to act reasonably to reduce that loss.[15] The upshot is usually that the plaintiff would not recover the amount he sought in full. So the action for debt is more appropriate as it, when successful, makes the full amount payable on the judgment. Where the mortgagee obtains an order for foreclosure the balance owing on the personal covenant is extinguished.

As a contractual right, the covenant to repay is subject to limitations.[16] Time will run from a demand for repayment, or where the mortgagor has made a written acknowledgement of liability, or if the mortgagor had made part payment.

(c) The creation of the 'equity of redemption', or the right to discharge the encumbrance, either as a contractual right for which time is of the essence, or, on the termination of such right, the indulgent equitable extension of the time for redemption. In the mortgage/charge the 'equity of redemption' becomes a fictional interest, supported by provisions enabling a release from the security on discharge.[17]

The equity of redemption was referred to in *Common Luck Investment Ltd v Cheung Kam Chuen (1999) 2 HKCFAR 229*, [1999] 2 HKC 719 where Litton NPJ, in commenting on the effect of a mortgage over New Territories land, said at 725 that:

> A right to redeem is an inseparable incident of a mortgage. It cannot be taken away by an express agreement of the parties. Although originally at common law the mortgagor forfeited his estate when he defaulted, and it became the absolute property of the mortgagee, from earliest times the courts of equity have intervened and held that until foreclosure by order of the court, or sale by the mortgagee in realising his security, the mortgagor has an equitable right to redeem. By offering to pay the principal, interest and costs he can have his property re-assigned to him. The mortgagor's equitable right to redeem is, in the eyes of the law, an equitable estate.
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> ...
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> It is inconceivable that the Hong Kong legislature could have intended to introduce, by enacting 25(1)(c), the harsh rule of the old common law without the mitigating effect of equity.

The courts have confirmed that the equitable rights take precedence over contractual provisions in the mortgage such as the clog on the equity of redemption.

15 See *Strong Offer Investment Ltd (In Liq) v Nyeu Ting Chuang* (2007) 10 HKCFAR 529, [2007] 3 HKC 234 (CFA).

16 *Fung Kam Cheung & Ors v Kwok Yiu Wing & Ors* [1991] 1 HKC 321.

17 Sections 55 and 56 of the Conveyancing and Property Ordinance.

## 3.5 The clog on the equity of redemption

**[11-18]** The clog was referred to in *Traffic Stream (BVI) Infrastructure Ltd v JP Morgan Chase Bank & Ors* [2005] 2 HKC 1, a mortgagor, of company shares, defaulted on its obligations under a debenture; the defendant was the trustee for the lenders. The mortgagor operated through Hong Kong subsidiaries. The loan money was used to finance projects in the Mainland. The defendant sought judgment in a US District Court for the amount due, and also replaced the directors of the Hong Kong subsidiaries. The defendant then sought to sell the subsidiaries interests in the projects. The plaintiff claimed the defendant had no right to take these steps. The defendant applied successfully to strike out the claim. The Court found that the debenture had given the defendant the rights it was seeking to enforce. Further, the defendant could sell the Hong Kong shares. This did not represent a clog on the equity of redemption, and the mortgagor would have been entitled to any surplus from the sale. It was said that per Reyes J at para 45:

> If there is a genuine clog on the equity of redemption, equity will zealously protect the mortgagor's interest. But that does not mean that the court can interfere with a legitimate exercise of a mortgagor's powers ...

In *Multiservice Bookbinding Ltd v Marden* [1979] Ch 84, the English Court of Appeal had considered the terms for redemption to ascertain whether they were *unfair and unreasonable*. As they had not been imposed in a morally reprehensible manner, the mortgage and loan represented a hard bargain between commercial parties. This meant the terms were not unfair and unreasonable which seemed to be shorthand for what was later promited as 'unconscionability'.

The modern clog approach seems to have three elements, namely:

(a) unconscionability rather than the effect of the stipulation is relevant;

(b) the neutrality of the identity of the parties so both commercial and consumer can seek to avoid the clause; and

(c) the reference to contractual defences, such as vitiating factors of undue influence and similar others, illustrating the involvement of equity.

**[11-19]** The clause contained in a mortgage – whether of chose in action, chose in possession, or land – referred to as a clog, is analysed on the basis of these elements. But put the clause in a collateral but independent document, not designated a mortgage, and the result may well be that it merely functions as a restrictive covenant (prohibiting redemption) and it escapes the need for examination as a clog. This becomes pertinent when the document containing the restrictive covenant. Decisions such as *Re Curtain Dream plc* [1990] BCLC 925, and *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA, Eng) considered whether the document was a sham – which was in reality a charge but unregistered due to the title of the document, or whether it functioned as a sale; the consequence of it being a sham meant the restrictive covenant was examinable as the true nature of the transaction was a security, *albeit* as a charge. The clause would then be viewed as a contract term for which general contract





defences were available; if it was viewed as part of a security then equity could allow relief if it was found to be unconscionability.

The remedies of the lender are enforceable in various ways against the land, but as a last resort in the common law courts by damages for breach of the contract, or recovery of a debt.

**[11-20]** In discussing the 'legal mortgage by way of legal charge by deed' over land in Hong Kong, the essential terms of a mortgage are applicable because although the form of the transaction is that of a mortgage/charge (albeit, a legal charge), yet the elements of a mortgage are make applicable by the operation of s 44(2), subject to terms to the contrary in the deed. Because the mortgage/charge is also a contract, it is possible for the parties to amend the traditional terms to suit their particular situation. But care must be taken to ensure that the inherent nature of the transaction is not defeated by that amendment, because amendment may result in the creation of an interest which is not a traditional mortgage and thus takes the transaction outside the definition of a security transaction over land.[18]

**[11-21]** Whilst it may be possible to consider the 'book debt' (as the entry in the books of a business) as distinct from the proceeds of the book debt, these attributes were part of the whole and should not be dealt with separately. In *National Westminster Bank plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209, the House of Lords said that the essential characteristic of a fixed charge "imposes restrictions on the chargor's use of his assets" whereas with a floating charge 'the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event'. It was all a question of control – where the chargor was in control of the assets, the charge was floating but when the chargee was in control the charge was fixed. For the fixed charge, the chargee had a proprietary interest in the assets. The situation in Hong Kong is somewhat different from that in England in relation to precedent because Art 84 of the Basic Law enables the court to decide whether or not to follow overseas decisions which are in *pari materia* with the law in Hong Kong. That Article provides in part that Hong Kong courts:

> ... shall adjudicate cases in accordance with the laws application in [the SAR] as prescribed in Article 18 and may refer to precedents of other common law jurisdictions.

Accordingly, if a court in Hong Kong wishes to follow Privy Council or, indeed, English Court of Appeal decisions, Article 84 would give it power to do so.[19]

**[11-22]** Whilst it is possible for the parties to rewrite some of the elements of the mortgage/charge, so long as the transaction retains the identity of a mortgage/charge, the terms of the Supply of Services (Implied Terms) Ordinance (Cap

18 *Cheang Kwok Sam v Chui Kin Wing* [1995] 1 HKC 637; *Ng Shou Chun v Hung Chun San* [1994] 1 HKC 155; *UTG Investment (Far East) Ltd v Petra Bank* [1995] 2 HKC 157.

19 See *China Field Ltd v Appeal Tribunal (Buildings) & Anor* (2009) 12 HKCFAR 342, [2009] 5 HKC 231 (CFA) and also *A Solicitor v The Law Society of Hong Kong* (2008) 11 HKCFAR 117, [2008] 2 HKLRD 576, [2008] HKCU 393 (CFA).

457) may well apply to the loan transaction, as representing a supply of services, and this could prevent certain of those agreed terms operating if contrary to the terms of the ordinance: see, for example, the effect of Unconscionable Contracts Ordinance (Cap 458); for example, on the terms of a credit card contract, in *Hang Seng Credit Card Ltd v Tsang Nga Lee* [2000] 3 HKLRD 33, [2000] 3 HKC 269. This decision did not affect the nature of the contract, a credit-card transaction, but the Ordinance did modify a provision adverse to the consumer credit-card holder. In any case, where the parties amend the terms of the contract, it is clear that no court will 'lend its aid' to construe a transaction which would enable the lender to avoid the terms of the Bankruptcy Ordinance (Cap 6) (for an individual bankrupt) or the relevant provisions of the Companies Ordinance (Cap 622) (for an insolvent company). In *Re Polly Peck (No 2)* [1998] 3 All ER 812, Mummery LJ observed:

> [T]he applicants seek an order from an English court retrospectively imposing on the assets of an insolvent company in administration in England a 'remedial constructive trust' giving them a proprietary interest in those assets. ... The imposed constructive trust would operate to exclude that asset from pari passu distribution by the administrators among the unsecured creditors ... in accordance with the legislative scheme prescribed in the 1986 Act. [at 822]
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> [T]here is no prospect of the court in this case granting a remedial constructive trust to the applicants ... since the effect of the statutory scheme applicable on an insolvency is to shut out a remedy which would, if available, have the effect of conferring a priority not accorded by the provisions of the statutory insolvency scheme. ... The insolvency road is blocked off to remedial constructive trusts, at least when judge driven in a vehicle of discretion. [at 827]

His Lordship also pointed out that even in the exercise of its discretion a court of equity cannot be used to avoid insolvency legislation.

## 4. Equitable Securities Over Land

**[11-23]** It is possible to have an equitable form of a charge and of a mortgage over land in Hong Kong. The differences between an equitable charge and an equitable mortgage were considered in *Swiss Bank Corp v Lloyds Bank Ltd* [1982] AC 584 at 594–595 where in the Court of Appeal, Buckley LJ said:

> An equitable mortgage is created when the legal owner of the property constituting the security enters into some instrument or does some act which, though insufficient to confer a legal estate or title in the subject matter upon the mortgagee, nevertheless demonstrates a binding intention to create a security in favour of the mortgagee, or in other words evidences a contract to do so ... An equitable charge which is not an equitable mortgage is said to be created when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realisation by judicial process, that is to say, by the appointment of a receiver or an order for sale ...

Limited remedies only are given the equitable mortgagee (foreclosure) and chargee (judicial sale). In each case it is usually possible to appoint a receiver – either by reference to the contract between the parties, or a court receiver. The equitable





mortgage can be created under the ordinance; for example, the mortgagor is in the process of purchasing the land, and is using the Conditions of Sale as the 'security interest' he is 'mortgaging' to the lender, or because that is what the parties had intended or, whilst intending to create a legal mortgage the parties had failed to validly execute a deed. This mortgagee has the remedies of a legal mortgagee so long as the equitable mortgage is created by deed; however, there is one remedy missing, namely the ability to sell the asset under the ordinance. Many such 'mortgages' take the form of assignments of the chose in action represented by the Conditions of Sale.

**[11-24]** Since 01 January 1970, no formal Government Lease has been issued in Hong Kong. The Conditions of Sale represent the contract entered into by the Government and the 'purchaser' at a public auction, or when the land is 'sold' by tender. Section 14 of the Conveyancing and Property Ordinance applies to: (a) provide that the interest of the purchaser is equitable on entry into the contract, and (b) once the conditions have been met, that interest converts to the legal estate in the land. Thus, the purchaser becomes the Government lessee who is commonly referred to as the 'owner' of the land. His interest is leasehold, and subject to re-entry by the Government on default of the conditions. But no formal document will be issued, hence the Conditions of Sale represent the first document in the chain of title. The Conditions of Sale can be deposited when creating an equitable charge or mortgage over the land. Alternatively, the mortgagor will be required to give the lender a power of attorney to enable the lender to deal directly with the asset on default, without the need for any judicial intervention. However, the ordinance also gives an equitable mortgagee, created by deed, the benefit (as appropriate) of exercising these statutory remedies bar one. That missing remedy is that the mortgagee cannot sell on default – or more correctly the equitable mortgagee cannot execute the assignment, or act as the conduit, for the passing of title to the purchaser; for this, assistance of the court is required.

**[11-25]** The rules relating to the creation of equitable securities are largely those of the common law. Often the only distinguishing factor between an equitable charge and an equitable mortgage is that of intention, and because the methods of creation of the relevant interest are often similar, there are strict rules relating to the creation of the equitable mortgage by deposit of title deeds in particular. A mere deposit of title deeds, without any written evidence of the intention to create the equitable mortgage (or conversely, the equitable charge) will be enough to create the equitable security. There must be an actual deposit because a mere oral agreement to do so does not result in an equitable mortgage.[20] In general, the deposit must be of the material's deeds, although not all documents in the chain of title are required.[21] There is no implied warranty on the part of the mortgagee that he will take reasonable care of the title deeds during the currency of the security.[22]

20 *Fullerton v Provincial Bank of Ireland* [1903] AC 309 (HL).
21 *Ex parte Wetherewell* (1787) Eng Rep 971.
22 *Gilligan v National Bank* [1901] 2 IR 513.

## 4.1 Equity and the mortgage

**[11-26]** The role of equity is very special in relation to mortgages; for it was one of the first identifiable examples of equitable relief against the penal bond. Equity later developed relief for the debtor in relation to an agreed sum clause in contracts by reviewing whether the clause amounted to liquidated damages (so no equitable relief was necessary) or a penalty (in which case the court would nullify and excise the clause). The penal bond was the iniquitous means adopted in early English common law to avoid the consequences of the prohibition on usury: usury was the charging of interest on a loan, ie *any* interest. From 1290 to 1571, usury was prohibited; from 1571 the prohibition was gradually relaxed, with varying interest rates becoming legal until 1854 when the prohibition was finally abolished in England. At that time, interest at 5% per annum was lawful. Hong Kong has never had legislation prohibiting usury.[23] As a result of the prohibition on usury, those lending money made use of several devices to obtain interest contrary to the spirit of the prohibiting legislation. The agreement underlying these devices was usually referred to as a penal bond; that is, a promise under seal together with provision for a penalty on default. The device of the penal bond involved: first, a loan was made which was repayable within a very short time but for which no interest was charged in accordance with the legislation. The loan was usually in the form of a promissory note. Secondly, the loan agreement provided that if the debtor did not repay by the due date, a penalty would be imposed. Frequently, the borrower had to link repayment of the promissory note to property he owned by making such property subject to forfeiture if the loan was not repaid by the due date. Of course, usually there was no intention that repayment would be made by the due date so that the 'penalty' acted as the interest.[24] Where the borrower did repay by the due date, the lender would dishonestly claim that he had not, and so would forfeit the property. As a result of the iniquities in the system, equity intervened to protect the borrower's interest especially where the borrower lost his property as a result of the fraud of the lender. This protection crystallised into the 'equity of redemption'.

## 4.2 Remedies for the legal mortgage/charge over land

**[11-27]** The Conveyancing and Property Ordinance (Cap 219) spells out the relevant remedies available to a legal mortgagee/chargee (and largely also to an equitable mortgage by deed), the requirements for the mortgagee/chargee selling the land have undergone several linguistic, and perhaps substantive changes, in recent years. These cases, including *Cuckmere Brick*, are discussed below. The statutory remedies for a statutory mortgage/charge are set out in s 50 (appointment of a Receiver), s 51 (powers of the mortgagee and the Receiver), s 53 (protection of

23 See Usury Ordinance, No 7 of 1844; and No 5 of 1886, and No 7 of 1886.

24 See Chapter 5 on developments in 'penalties'; *Paciocco v ANZ Banking Group Ltd* [2016] 333 ALR 569 (HCA); and cf *Cavendish Square Ltd v Talal El Makdessi* [2016] 2 All ER 519 (SC); on assessment of damages, see: *Cavendish Square Ltd v Makdessi* [2017] EWHC 650.





the purchaser from the exercise of remedies), and supported by a list of remedies and powers in Sch 4. There is no need for the statutory mortgagee/chargee to approach the court for an order for sale. But if there is some doubt about the validity of the mortgage/charge, for example, questions about whether a company mortgagor/chargor has not observed the 'proper purposes' for which the company can contract, the mortgagee/chargee may seek a court order to ensure that there are no subsequent difficulties with shareholders. In general, the statutory mortgagee/chargee has the full remedies of a traditional mortgagee, despite the terminology used and the nature of the form of the security.

**[11-28]** The mortgagor, in the traditional form, had transferred his land, yet he had a recognisable and enforceable right to redeem the property even beyond the due date of repayment of the debt. If the mortgagee sought to exercise remedies, equity would intervene if the mortgagee's conduct was inequitable by disregarding the rights of the mortgagor as exemplified in the equity of redemption. Traditionally, the obligations of the mortgagee were examinable by reference to equitable principles. That is until the case of *Cuckmere Brick Co Ltd v Mutual Finance Co Ltd* [1971] 2 WLR 1207 where the Court of Appeal said that the mortgagee only had a duty to take 'reasonable care to obtain … the true market value', or a 'proper price' at the date of the sale. Despite the fact that *Cuckmere Brick* is considered to represent the acceptable view it was predicated on negligence, thus a duty of care, rather than the more traditional and appropriate one of equity. In *Cuckmere Brick*, it was said that the duty rested in the tort of negligence in the same way as it did in *Donoghue v Stevenson* [1932] AC 562 (HL); thus, the neighbourhood principle from that latter case applied in *Cuckmere* because 'the proximity between [mortgagor and mortgagee] could scarcely be closer'. Surely, they are 'neighbours' [at 966]. This is a more onerous obligation than that of 'good faith', or the need to act honestly, as examined in equity.[25] In *Cuckmere Brick*, there were two duties required: (i) the duty to act in good faith, that is, 'to act honestly and without reckless disregard for the mortgagor's rights'; and (ii) the duty to 'take reasonable care to obtain whatever was the true market value of the mortgaged property at the time he chose to sell it'.

**[11-29]** The English Court of Appeal in *Parker-Tweedale v Dunbar Bank plc* [1990] 2 All ER 577 (in respect of the mortgagee's sale), and the Privy Council in *China and South Sea Bank v George Tan* [1990] 1 AC 536 (in respect of the rights of the surety on the sale by a lender) firmly restated the traditional, and correct, principle that the mortgagee's duties in respect of the equity of redemption are examinable primarily by reference to equitable principles as this arises from the particular relationship between mortgagor and mortgagee. In *China and South Sea Bank*, Lord Templeman said at 543 that:

> The tort of negligence has not yet subsumed all torts and does not supplant the principles of equity or contradict contractual promises or complement the remedy of judicial review or supplement statutory rights.

25 See *Standard Chartered Bank v Walker* [1982] 3 All ER 938 (CA), and *Silven Properties Ltd & Anor v Royal Bank of Scotland plc & Ors* [2004] 4 All ER 484 (CA).