

6 March 2003

Your Ref: CB1/BC/6/01

Ms. Becky Yu
Clerk to Bills Committee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Ms. Yu

Bills Committee on Companies (Amendment) Bill 2002

Thank you for your letter of 4 March 2003.

As we understand it, the main purpose for amending sections 157H and 157I is to expand the scope of the prohibited transactions to include “quasi-loans” and “credit transactions”. The substance of sections 157I(2) and 157I(3)(b) remains unchanged.

We have some difficulties in understanding the legislative intent and the effect of sections 157I(2) and 157I(3)(b).

1. Under section 157I(2), any security provided by a company in contravention of section 157H(2) shall be unenforceable against the company, but this is subject to section 157I(3).
2. Under section 157I(3)(b), it is provided that section 157I(2) shall not affect an interest in any property which has been passed by the company to any person by way of security provided in connection with any loan.
3. Under section 157I(5), it is said that without prejudice to the foregoing provisions of section 157I, section 157H(2) shall not of itself invalidate any transaction entered into in contravention thereof.
4. On the one hand, the security provided by a company is unenforceable against the company, yet at the same time the transaction is not invalidated and the interest in any property which has been passed by the company to any person by way of security is not affected.

5. If, for example, a company mortgaged a property to a bank to secure a loan to a director in contravention of section 157H(2), it seems that as between the bank and the company, the bank cannot enforce the mortgage by entering into possession, foreclosure or exercising the power of sale, yet the interest in the property mortgaged to the bank remains with the bank, so that the bank can hold onto the mortgage until the loan is repaid. In other words, even though the mortgage is not enforceable yet the bank would still have the benefit of the mortgage in that (1) the bank can hold onto the mortgage as security, (2) the company is not entitled to a release of the property from the mortgage until the loan is repaid and (3) the company cannot sell the property to a third party free from the mortgage. Is this the intention?

6. If the bank nevertheless sells the property, in purported exercise of the power of sale under the mortgage, and the property is sold to a bona fide purchaser for value without notice of the contravention of section 157H(2), does the third party obtain good title of the property free from the mortgage and the interest of the company?
 - (i) It seems that as a matter of principle and on the interpretation of the relevant provisions in section 157I, the innocent third party should obtain good title.
 - (ii) Firstly, this is consistent with the general principle that a bona fide purchaser for value without notice of prior irregularities should obtain good title.
 - (iii) Secondly, section 157I(3)(b) specifically provides that the interest in any property which has been passed by the company to any person by way of security shall not be affected and section 157I(5) provides that a contravention of section 157H(2) shall not of itself invalidate any transaction entered into in contravention thereof. These two subsections suggest that the innocent third party should get good title, and since the third party is not seeking to enforce any security against the company, section 157I(2) does not apply.
 - (iv) Difficulty, of course, lies in the apparent contradiction between section 157I(2) and sections 157I(3)(b) and 157I(5).
 - (v) This apparently is not the view taken by the Administration of the effect of the relevant provisions. In paragraph 8 of the paper CB(1)989/02-03(02) of February 2003, it is said that because interest in the property can successfully pass to the chargee, a third party can validly acquire an interest in the property from the chargee. However,

as the chargee cannot enforce the security against the company, any third party who acquires an interest in the property from the chargee cannot similarly enforce the security against the company. We do not know whether this statement is intended to be directed at (1) the situation where the third party acquires the property upon a purported exercise of the power of sale under the mortgage, and expects to obtain title of the property free from the mortgage and from the interest of the company, or (2) a situation where the third party (for example another bank or a mortgage corporation) acquires the mortgage itself. The question is also whether a distinction should be drawn between the two different situations and whether there should be any distinction at all given that in either case the third party is innocent.

7. What is the legislative intent regarding the position of an innocent third party (for example another bank or a mortgage corporation) who purchases the mortgage, instead of the property? See our comments in paragraph 6(v) above.

We would like to see a clarification of the legislative intent and clearer language in the legislation to express the legislative intent. In our view, the position of an innocent third party (be it a purchaser of the property who expects to obtain good title free from the mortgage or the interest of the company, or a bank or a mortgage corporation acquiring the mortgage) should be protected.

Yours sincerely

Louis Loong
Secretary General

c.c. Mr. Stewart Leung, Vice Chairman, Executive Committee