RESPONSE TO LETTER DATED 10TH APRIL 2O03 FROM THE REAL ESTATE DEVELOPERS ASSOCIATION OF HONG KONG

1. We refer to the letter dated 10th April 2003 from the Real Estate Developers Association of Hong Kong ("REDA") to the Bills Committee on the Companies (Amendment) Bill 2002 ("the Letter").

2. In Paragraph 1 of the Letter, REDA questioned the legal basis for the Administration's view that it is possible that the mortgagee under a legal mortgage cannot assign the legal estate in the land to the purchaser. We set out our analysis as follows:-

   2.1 We think that there is no clear answer to the question whether a sale by a mortgagee of a legal or equitable mortgage comes within section 53 of the Conveyancing and Property Ordinance ("CPO"). On one hand, it can be argued that since the mortgage is unenforceable, the mortgagee does not have any power of sale, whether or not it has an estate or interest in the land. If it sells, it is not "selling under an express or statutory power of sale" since section 53 of CPO only applies to cases where the mortgagee has a power of sale. On the other hand, it can be argued that like any other mortgages, if the borrower defaults, the power of sale has arisen even though it cannot be exercised. Therefore, when the mortgagee sells, it is "selling under an express or statutory power of sale" albeit that the power has been exercised unlawfully or improperly.

   2.2 Assuming that the sale comes within section 53 of CPO, we think that it is unclear whether such sale can benefit from section 52 of CPO. We set out both sides of the argument:-

   Section 52 of CPO Does not Apply

   (a) Section 52 does not apply because none of the three limbs stated therein is wide enough to cover the case where the mortgagee sells under an unenforceable mortgage. The first limb, "no case had arisen to authorise the sale", indicates that upon satisfaction of certain conditions, a case will arise to authorise the sale but such conditions have not been met; e.g. where the mortgage money has not become due. This does not apply to the present case because no case will ever arise to authorise the mortgagee to sell the property.[1]

[1] Since the mortgage is unenforceable by operation of law, it does not appear to us that the court has the power to authorise the sale.

(b) The second limb, due notice not having been given, is irrelevant if the mortgagee has given notice or where notice does not need to be given (Para. 11 (b) and (c) of Schedule 4 to CPO).

(c) As regards the third limb, "the power was otherwise improperly or irregularly exercised", by virtue of the principle of statutory interpretation, *ejusdem generis*, the wider residuary words "or otherwise improperly or irregularly exercised" which follow "that due notice was not given" should be restricted by matters of the same limited character as the preceding words. That is, the improper or irregular exercise of the power should only be related to procedural impropriety or irregularity. It does not cover an unlawful exercise of the mortgagee's power.

(d) If section 52 were applicable, it means that the mortgagee can validly and effectively exercise its power of sale. This flatly contradicts with section 157I(2) and frustrates the intention of the legislature behind it because enforcement of the mortgage against the company is clearly prohibited by that section.

Section 52 of CPO Applies

(e) The three limbs in section 52 should not be narrowly and literally construed. It is clear that the intention of the legislature is to protect the purchaser of a property where the sale is made under a mortgage so that irrespective of how the power of sale has been exercised, the purchaser's title to the property should not be affected. If a mortgagee proceeds to exercise its power of sale under an unenforceable mortgage, such power has been exercised irregularly or improperly. Section 52 applies and the title of the purchaser shall not be affected by such irregularity or impropriety.

(f) The above interpretation does not frustrate the intention of the legislature behind section 157I(2) or tilt the balance in favour of the mortgagee because section 52 provides that any person who suffers loss through an unauthorised, improper or irregular exercise of the power of sale shall have a remedy in damages against the person exercising the power. In other words, the company may recover damages from the mortgagee for the irregular or improper sale.

2.3 It can be seen from the above that whether sections 52 and 53 of CPO apply can be argued both ways. Therefore, we do not agree with REDA's submission in Paragraph 1(iv) that there can be no doubt that the mortgagee under a legal charge has the power to assign the legal estate to a purchaser in exercise of an express or statutory power of sale. This statement fails to take into account section 157I(2), which provides that the mortgage is unenforceable against the company.

3. In relation to Paragraph 2 of the letter:-

3.1 We do not dispute sub-paragraph (i).

3.2 In relation to paragraph (ii), we do not wish to engage in argument with REDA as to whether it is the practice of banks in Hong Kong to apply for an order for sale. Suffice it to say, REDA admits in (b) that the bank will need to obtain an order for possession if the property is self-occupied by the mortgagor or by the mortgagor's tenant. In this connection, we would add that it is very rare that mortgagee banks are in possession of the mortgaged property or that possession will be delivered up to the mortgagee voluntarily. Where the mortgagee bank applies to court for an order for possession and if the court is informed that the mortgage is unenforceable, it is unlikely that the court will grant the order in terms of the application. If the bank does not have possession of the property, we wonder how it can sell the property to a bona fide purchaser for value without notice of the contravention of section 157H. Viewed in this perspective, whether the mortgagee needs to apply for an order for possession or an order for sale makes little difference in practice. In most cases, without either of them, the mortgagee cannot sell the mortgaged property.

3.3 As regards (iii), again, we do not intend to argue with REDA on solicitors' practice. However, we note that the Law Society does not find any problem with section 157I. This supports our view that solicitors acting for purchasers do act prudently to ensure that the bank has exercised its power of sale properly. In light of the prevailing market sentiment which is strongly in favour of the purchaser, it appears that a prudent solicitor should not have difficulties in insisting on and obtaining an order for sale as part of the process of proving good title.

3.4 In relation to (iv)(a), we agree that the fact that the mortgage was executed in breach of section 157H(2) may not be apparent on the face of the security document. However, the mortgage document will invariably show the name of the borrower. Hence, if the borrower is a natural person whilst the mortgagor is a limited company, the purchaser's solicitor should have suspected that the borrower might be a director or a connected person of a director of the mortgagor. If the relation between the borrower and the mortgagor cannot be ascertained from a company search of the mortgagor, the purchaser's solicitor would have enquired from the solicitors acting for the bank the relation between the borrower and mortgagor and whether the loan is prohibited under section 157H. Even if the borrower is a company controlled by a director of the mortgagor through nominees, the same query should have been raised. The company search of both the mortgagor and borrower will reveal that the two companies are not parent and subsidiary and one would have queried why the mortgagor is prepared to provide security to another company that is apparently unconnected with it.

3.5 On Paragraph (iv)(b), we disagree with REDA's interpretation of Sections 157I(3)(b) and (5). The former clearly provides that *"Sub-section (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."* (our emphasis). By virtue of the underlined wording, it is beyond doubt that sub-section 3(b) only applies to the mortgage or other types of security provided by the company in connection with the prohibited loan. It does not extend to the interest purported to be passed by the mortgagee to a third party. As regards the latter, it clearly states that *"…section 157H(2) shall not of itself invalidate any transaction entered into in contravention thereof."* (our emphasis). Again, by reason of the highlighted wording, section 157H(5) only applies to the loan prohibited by section 157H(2), not sale of the property by the mortgagee.

3.6 On Paragraph (v)(a), it is our understanding that in assessing whether to grant credit facilities to a customer, banks in Hong Kong will ensure that the security provided or offered by the borrower is sufficient, valid and enforceable. (The Hong Kong Monetary Authority has also published a Supervisory Policy Manual to advise banks in Hong Kong that credit appraisals should entail a careful consideration of, amongst other things, the validity of collateral.) Where the borrower is a director or connected person of a director of a company in Hong Kong and

the security is provided by the company, banks will be advised to ensure that the security so provided will not be caught by section 157I. For instance, if the company is a private company and is not related to any listed company in Hong Kong, steps will be taken to ensure that the loan is properly approved by the company in general meeting so that the exception in section 157H(3)(b) applies.

3.7 Therefore, we are surprised by REDA's statement that "more likely than not, the bank is not aware that the mortgage may be unenforceable against the company by reason of a contravention of section 157H(2)." If section 157I(2) poses practical difficulties to banks in Hong Kong , we fail to see why the Law Society and the Hong Kong Association of Banks voice little complaint about this provision since its enactment in 1984 and why they are still satisfied with its re-enactment in the captioned Amendment Bill.

3.8 The observation in paragraph (v)(b) is overly generalised. When the bank demands payment of the loan from the company, the director who has directly or indirectly benefited from the prohibited loan might have resigned from the company or have lost his influence over the board. As a result, it is not unlikely that the company will refuse payment on the ground that the mortgage is unenforceable.

3.9 We do not agree that the statement, "it is very unlikely that the mortgagee and its legal advisers will run the risk of deceiving the court by concealing the fact that the mortgage is unenforceable when applying for an order of possession or an order for sale", is misleading. By virtue of the words "deceiving" and "concealing", it is clear that this statement deals with the situation where the bank <u>knows</u> that the mortgage is unenforceable. Where the bank knows that the mortgage is unenforceable, we maintain our view that the bank will not, in most cases, deceive the court by concealing the fact that the mortgage is unenforceable. Therefore, the observation in paragraph (vi) that "given that the bank and their legal advisors would not normally be aware that the mortgage is unenforceable by reason of section 157I(2)" bears little relevance to the statement.

4. For the reasons stated above, we do not agree with the concluding paragraph of the Letter. If sale by a mortgagee under an unenforceable mortgage creates a real rather than an academic problem on the position of the third party purchaser, we wonder why there is little textual or judicial discussion on this topic, not to mention the scarcity of litigation before the court.

Department of Justice
May 2003