# HONG KONG BAR ASSOCIATION'S
## Comments on Proposed Sections 157I(2) and 157I(3)(b) under the Companies (Amendment) Bill 2002

1. The Bar is asked for its views on the proposed ss.157I(2) and 157I(3)(b) under the Companies (Amendment) Bill 2002. The structure of the relevant provisions in the current legislation is as follows. S.157H sets out the prohibition on loans etc. by a company to its directors. S.157I sets out the civil consequences of transaction contravening s.157H. The Companies (Amendment) Bill 2002 has retained this structure, with a proposed new s.157H that expands the prohibitive provisions. Amendments are also proposed for s.157I.

2. S.157I(2) currently provides:

> "*Subject to subsection (3), a guarantee entered into or any security provided by a company in contravention of section 157H(2) shall be unenforceable against the company.*"

The only amendment proposed to it under the Bill is that "*157H(1), (2) or (4)"* be substituted for A*157H(2)"*.

3. S.157I(3)(b) currently provides:

> *"(3) Subsection (2) -*
> *(a) ...*
> *(b) shall not affect an interest in any property which has been passed by the company to any person by way of security provided in connexion with any loan."*

After the amendment, it will read:

> *"(3) Subsection (2) -*
> *(a) ...*
> *(b) shall not affect an interest in any property that has been passed by the company to any person by way of security provided in connection with any transaction or arrangement."*

4. It can be seen that only minor amendments are being proposed to ss.157I(2) and s.157I(3)(b) which do not appear to alter those legislative provisions in substance. The statement in paragraph 12 of the Administration's Paper CB(1) 395/02-03(1) that "*These two new sections are a reinstatement of the existing sections 157I(2) and 3(b) of the Ordinance"* thus appears to be correct. This does not mean, however, that the substantive effect of these provisions should not be examined in light of the wider changes being proposed to the law on loans to directors generally.

5. S.157I is derived from s.52 of the Companies Act 1980 of the United Kingdom (which later became s.341 of the Companies Act 1985), but s.157I has been different from s.52 right from the beginning. Whereas the UK provision makes the transaction voidable at the instance of the company, the HK provision makes any guarantee or security unenforceable against the company, although it does not affect an interest in any property that has passed from the company to any person by way of security.

6. We have not been able to find any previous judicial consideration of these provisions. The explanatory memorandum in the Companies (Amendment) Bill 1983, when it dealt with what became s.157I, i.e. clause 114 of the Bill, did not give any clue as to how these provisions were supposed to operate. We attach a copy of the relevant extract from the explanatory memorandum. One is therefore left to construe these provisions as best one can and to attempt to ascertain their precise legal effect.

7. As far as a guarantee is concerned, the plain meaning of the proposed legislation is that a guarantee given by a company in favour of a director or his related company, in contravention of s.157H(1), (2) or (4), shall be unenforceable.

8. The position as to security is more complicated. Any security given by a company in favour of a director or his related company, in contravention of s.157H(1), (2) or (4), shall be unenforceable, and yet it is provided that this shall not affect an interest in any property which has passed by the company to any person by way of security in connection with the transaction or arrangement. The point of difficulty arises out of the antithesis between the validity of the transfer (or passing) of property as an aspect of the creation of the security on the one hand and the plain words in s.157I(2) that such security is not to be enforceable on the other. Take two very common types of security: legal charge on land and share mortgage.

*Legal Charge on Land*

9. Take the case of a mortgage of some landed property as security for a loan made by a third party to a director in breach of s.157H. Since s.157I(2) is subject to s.157I(3), one starts with s.157I(3). The existing s.157I(3)(b) provides that:

> *"subsection (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 connexion with any loan"*.

10. First, there is the problem of whether a legal mortgage of land by way of legal charge can be said to be a case of "an interest in any property which has been passed by the company" to the mortgagee. There is plainly no passing of property. Rather, an interest is created. This is perhaps not the most difficult point because one may envisage that a court, adopting a purposive approach of construction, would construe the creation of a security interest in the property as falling within the meaning of the words "an interest in any property which has been passed by the company".

11. By virtue of s.157I(2), a legal charge on land would be unenforceable against the

company. So the mortgagee would not be able to obtain an order for possession and sale or foreclosure. The provision under s.157I(3)(b) that the passing of an interest in the property is not affected is little comfort to the mortgagee, since after 1984 the legal estate is not transferred to the mortgagee under a mortgage of land.

12. The position is further complicated by the provisions of the Conveyancing and Property Ordinance relating to a mortgagee's right of possession. There is doubt as to whether, in the light of section 157I(3)(b), it would be necessary for a legal mortgagee to "enforce" the mortgage in order to obtain possession of the property. At common law the legal mortgagee's right of possession arises as soon as the mortgage is created and his right to possession stems from his legal title to the property. S.44(2) of the Conveyancing and Property Ordinance provides that:

> *"(2) Under a mortgage effected by a legal charge, the mortgagor and the mortgagee shall, subject to this Ordinance, have the same protection, powers and remedies (including but not limited to those relating to foreclosure and the equity of redemption but excluding the power of the mortgagee to enter into possession before any default by the mortgagor) as if the mortgage had been effected by way of assignment of the legal estate before the commencement of this section."*

13. The common law right to possession is only modified by statute in respect of any time "*before any default by the mortgagor*". Thus it is highly arguable that the right to possess would automatically arise as soon as the mortgagor is in default. Anyway, it is not always the case that the mortgagee has to enforce its right to possession by action. If the mortgagor is in possession, then an action for possession may often be necessary. However, if the mortgaged property is tenanted, then the right to possess may often be exercised by the mortgagee's serving a notice on the tenant to pay rent to the mortgagee. Very rarely in such a situation would it be necessary to take out an action.

14. The question arises as to whether this right to receive rent and income upon default is taken away by s.157I(2) which makes the security unenforceable against the mortgagor, subject to s.157I(3)(b). It seems to us that it does not, but the issue is not entirely free from doubt. The tenant of mortgaged land may be put in a dilemma once he is aware that the mortgage was created in breach of s.157H(2)(b). (The position is somewhat different in the case of payment of dividends in a mortgage of shares. The company is enjoined from taking notice of any equitable interest in the shares and thus may justifiably pay the dividends to the registered owner even though the company is aware of the mortgage or the nullity of the mortgage.)

15. Paragraph 12 of the Paper No. CB(1) 395/02-03(1) from the Financial Service Branch appears to suggest that because if a mortgagor wished to sell the property, he would have to discharge the mortgage since the mortgage would in all probabilities be duly registered, therefore the mortgagee's interest is protected and a balance is struck between the company and the mortgagee.

16. While in practice the company mortgagor may take steps to discharge the mortgage, the strict legal position is more complicated. If the mortgage is unenforceable as against the

mortgagor, as stipulated in s.157I(2), it seems that the mortgagor may apply to the Court for an order to vacate the registration of the mortgage in the Land Registry. In *Anstalt Nybro v Hong Kong Resort Ltd*. [1980] HKLR 76, the Privy Council held that a valid contract granting an option to participate in joint development of land would cease to be registrable under the Land Registration Ordinance once it was shown that it would no longer be enforceable by specific performance because it ceased to affect land. In *Ally Town Investment Ltd. v Weng Seng Heng Land Investment Ltd.* [1995] 3 HKC 242, Findlay J. held that in the light of the 6-year limitation period for the recovery of money under a mortgage, the proper inference was that a mortgage registered in 1915 had been properly discharged and that the title to the land was a good one. Accordingly, under the existing provisions, upon the mortgagor showing that the mortgage is not enforceable against him, he may argue that the court should order the removal of the registration of the mortgage. After the registration is vacated, a purchaser from the mortgagor would acquire a good title even against the mortgagee by virtue of s.4 of the Land Registration Ordinance, notwithstanding that he in fact has notice of the mortgagee's interest (see *Fast Forward Ltd. v Magicsound Co. Ltd. & others* [1991] 1 HKLR 277).

*Legal Mortgage of Shares*

1. The consequences may be different for a legal share mortgage (as opposed to a mere equitable one), where the shares would be transferred to and registered in the name of the mortgagee. In that case, it may be that the mortgagee can exercise self-help and dispose of the shares upon the borrower's default, since the interest in the shares passed to the mortgagee is not affected by virtue of s.157I(3)(b). Although the mortgage is Aunenforceable≅ as against the company by virtue of s.157I(2), it is unnecessary for the mortgagee to take any legal action to "enforce" it.

18. There is, however, still a question in such circumstances as to whether the company mortgagor could nevertheless serve a stop notice in respect of those shares to prevent the mortgagee from transferring them. The company in which the shares are held does not take note of any equity of redemption. It may be that despite that the mortgage is by s.157I(2) rendered unenforceable, the mortgagor could still claim that it is entitled to an interest in the shares so as to bring it within Order 50 rule 11. Of course in such a case the effect of a stop notice is merely to make it mandatory for the company to notify the mortgagor of any intended transfer and does not prevent the transfer of the shares by the mortgagee. But the mortgagor may yet apply for an injunction (and may probably get an interlocutory one at least) to restrain the transfer or for a declaration that the transferee holds the share subject to the rights of the mortgagor.

19. Irrespective of whether the Court would or would not ultimately grant the injunction, there seems no reason why the Court should not grant the declaration sought because the interest that has passed is a security interest, leaving the equity of redemption intact. Furthermore, in the scenario postulated, namely, where the mortgagor has served a stop notice, it would be unlikely that the buyer or transferee does not know of the "equity" of the mortgagor by the time of the intended transfer of legal title even though he might not have had notice at the time of the contract. In such circumstances it would be difficult for the buyer or transferee to claim to be a bona fide purchaser without notice because,

in order to benefit from this doctrine, the purchaser needs to have acquired the legal estate without notice (see *Snell's Equity, 30th ed, para.4-14*).

20. If this is right, the result is that in the case of a legal mortgage of shares, even though the shares are transferable by the mortgagee, there are ways for the mortgagor to make sure that the subsequent transferee holds them subject to the rights of the mortgagor.

21. What then are the rights of the mortgagor? One such right is to insist that, on the sale of the shares, the proceeds are used towards the repayment of the mortgage debt. As to the dividends on the mortgaged shares, insofar as the dividends in the hands of the original mortgagee are concerned, clearly they have to be used towards repayment of the mortgage loan. The position regarding dividends received by the subsequent purchaser or transferee is less clear. On the assumption that he takes the shares subject to the rights of the mortgagor, then he should likewise use the dividends he receives and any sale proceeds to discharge the mortgage debt. But what if all the debts have been discharged? Would the mortgagee or his transferee be able to keep the further dividends or the proceeds of sale? It would appear that the answer is "no", because this would be the right of the holder of the equity of redemption. Furthermore, s.157I(2) merely says that the security shall be unenforceable against the company. Presumably this means that the security (or, more precisely, the equity of redemption) is enforceable *by* the company as the mortgagor. If this is the case, then it seems that s.157I(3)(b) would be devoid of value at least in the case of mortgage of shares.

22. It appears that the situation would in practice not be much different in the case of an equitable mortgage of shares where the share scripts together with the duly executed instruments of transfer with the name of the transferee left in blank are deposited with the mortgagee. If the mortgagee completes his legal title before the mortgagor issues any stop notice it would appear that the mortgagee would be in the same position as the mortgagee in a legal mortgagee. If the stop notice is issued before the completion of the transfer of legal title, then in practical terms there is hardly any benefit to be gained by the equitable mortgagee from the mortgage.

*Possible Reform*

23. In conclusion, the concern expressed in the letter dated 4 March 2003 from the Clerk to the Bills Committee seems to us to arise from the difference between the position under the existing Hong Kong legislation and its UK counterpart, which we have discussed above. The proposed amendments to s.157I on which we are asked to comment do not, in our view, make any material difference.

24. In the light of the above analysis, the suggestion that the antithesis between ss.157I(2) & 157I(3)(b) strikes a balance between the interest of the mortgagor company and the mortgagee because under certain circumstances the company might be forced to discharge the mortgage seems to us to be somewhat unrealistic.

25. In fact, it appears that the only instance when it would be practically safe for the lender to obtain a security is the case of a chattel mortgage, where the lender becomes a holder

of a duly registered bill of sale or takes actual possession of the chattel. But this kind of security is rarely encountered in practice.

26. While the difference in the positions under the English and Hong Kong legislation may not have had much impact as yet, this may in part be due to the relatively narrow range of transactions that would be caught by the existing s.157H. The proposed amendments will not alleviate the concern we have raised earlier. On the other hand, the proposed amendments to s.157H will expand the applicability of these provisions to a much wider range of transactions. It is therefore possible that the impact of s.157I will be significantly greater following these amendments.

27. Thus, if our view of the effect of the differences between the HK and UK legislation (which we have described above) is correct, and if this is a matter of serious concern, this is perhaps a matter which should be taken into account by the Bills Committee. We would suggest adopting the same solution as in section 341 of the Companies Act 1985 in the UK.

Dated on 2 May 2003